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CIS

INTEREST RATES AND BUSINESS CREDIT NEEDS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

INTEREST RATES AND BUSINESS CREDIT NEEDS

PART 2

HARTFORD, CONN.—OCTOBER 13, 1981
NEW YORK, N.Y.—OCTOBER 14, 1981
MEMPHIS, TENN.—OCTOBER 19, 1981

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
88-231 O WASHINGTON : 1981

5721-5

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INTEREST RATES AND BUSINESS CREDIT NEEDS

TUESDAY, OCTOBER 13, 1981

U.S. Senate,
Committee on Small Business,
Hartford, Conn.

The committee met, at the State Capitol, Senate chambers, room 310, Hartford, Conn., Hon. Lowell Weicker, Jr., chairman of the committee, presiding.

Present: Senator Weicker.

Also present: Robert J. Dotchin, staff director, and James J. O'Connell, economist.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SENATE SMALL BUSINESS COMMITTEE

Senator Weicker. The U.S. Senate Committee on Small Business today is continuing its hearings on the problem of high interest rates and their devastating effect on our economy.

The committee so far has heard from all the experts on this problem, including the administration and the Federal Reserve Board, the very people, by the way, who put us in this mess in the first place.

I decided to convene this hearing in Hartford because I want to hear it like it is, so to speak. The rarified atmosphere of Washington can cause one to lose sight of what's really happening on Main Street, America.

I'm a little fed up with all the elegant economic theory, especially the supplyside theology that preaches either that all will go well if only we will be a little patient, or, worse, that what is happening in the country is not supposed to be happening according to their calculations.

High interest rates are having a disastrous effect on the daily lives of middle-class America. It has become a survival test. It is not some academic exercise. This is the real world, and I'm beginning to wonder whether the experts realize that.

Thousands of small businesses—homebuilders, auto dealers, realtors, farmers—are going down the tubes because of high interest rates, and their employes and communities are going down the tubes with them. There were 11,000 bankruptcies in the first 8 months of 1981 alone, almost 50 percent above last year.

I think we have some very difficult decisions to make in the next few months. The Federal budget deficit is soaring almost out of control, largely because the tax cuts are twice as large as the spending cuts, and defense sepending has little relation to a sound defense.

I'm looking forward to hearing the comments of our witnesses. I deeply appreciate your taking the time to be with us today, and assure you we will pay close attention to what you say. I'm not half so interested in redeeming party platforms as I am in keeping alive the promise of economic opportunity in America.

Our first witness is Senator Carl Zinsser of the fourth district. Senator Zinsser, welcome, and we look forward to your testimony.

STATEMENT OF HON. CARL ZINSSER, STATE SENATOR, FOURTH DISTRICT, MANCHESTER, CONN.

Mr. ZINSSER. Thank you, Senator. I'm glad to see you back in Hartford, and I'm glad you can bring the meetings out of Washington, except I feel a little inadequate in trying to tell you what to do about higher interest rates. You said you've heard from the experts, and I'm not an expert, but I believe it's become the No. 1 problem in the country.

I am a State senator, and I do represent the fourth senatorial district, and I am also a realtor, so I know where it's coming from.

The Federal Government, in an attempt to bring about a healthy, stable economy, is caught in a catch-22 situation. On the one hand, the Federal Reserve has enacted a policy of tight money to bring down the spiraling inflation rate to an acceptable level. On the other hand, the administration, with the cooperation of the Congress, has embarked upon a program of budget cuts and tax cuts which were long overdue, in an attempt to bring inflation down and at the same time stimulate the economy to the private sector.

It would appear that inflation is, in fact, on the way down. But the price that we are paying to bring it down is a historic high in real interest rates, the price of money after allowing for inflation. I am not sure which is worse, high inflation or high interest rates.

All facets of the national economy are hurt by high interest rates: stocks, autos, housing, and busineses in general. High interest rates have become the No. 1 domestic problem. In stocks, why should the American people risk investing in the stock market when the Government guarantees a return of 15 percent on Treasury bills and money market mutual funds are paying even more?

In housing, how is it possible for a young couple looking to buy their first home, and having to look at mortgage payments on a $50,000 30-year 18-percent mortgage of $753.53 per month, plus taxes, which brings the payment up to approximately $850 per month or $10,200 annually? Compare that with an interest rate of 11 percent just 2 or 3 years ago and a savings about $300 per month or $3,600 annually.

In a recent issue of the U.S. League of Savings Associations membership bulletin, they have, I believe, summed up the problem in one paragraph:

> The President's entire "supplyside" economic program is now in jeopardy because of high interest rates. The cornerstone of "supplyside" programs was that the tax cut would mean huge increases in private savings and investment, leading, in turn, to greater prosperity, more jobs and profits, and more tax revenue. But the extraordinary level of interest rates means a sluggish economy, lower tax revenues, higher Federal deficits, and increased Treasury borrowings, soaking up the savings that were intended to bolster private investments.

Therefore, I believe that it is essential that the Congress, in a bipartisan move, support the President's call for further budget cuts, and also that the President be willing to make additional cuts in defense spending in order to keep the Federal deficit at the projection $42.5 billion.

Additionally, I believe that we need to insure that Federal regulations help, not hinder, the growth of housing opportunity. I call upon the Congress to support the Duncan-Sasser amendment, which will help support the bonding authority of agencies such as the Connecticut Housing Finance Authority, by making certain that these bonds retain their tax-exempt status.

High interest rates can and must be brought down, and will be if the Congress and the President work together for the common goal of lower rates. This is no time for politics as usual. The stakes are too high.

I thank you, and I'll answer any questions you have.

Senator WEICKER. Carl, thank you very much. One of the areas of concern that you've so eloquently touched upon is the inability of young people to buy housing. Now, we had testimony from a Connecticut builder in Washington a month ago that clearly pointed this out. He was building middle-income housing up in eastern Connecticut, and the fact is housing starts just ground to a standstill.

The best projections that I am able to see and the latest, I believe, in a survey conducted by U.S. News & World Report that appeared yesterday, would indicate in the next several years, that probably 15 percent would be the floor, and that mortgage rates probably would be somewhere around 15, 16, 17, 18 percent.

If that continues, do you see any change, then, in the inability of people to buy homes in this country?

Mr. ZINSSER. I think the one thing that we need more than anything else is a stable economy so that a builder, for example, can plan 2 or 3 years down the road and know what his costs are going to be. It's almost ironic to me—I've been in this business now, in the real estate business, since 1966—and recently, through the Yankee Mac program, when I saw people lining up to get a 13¼-percent mortgage, it was mind boggling.

I think that the situation is even made worse by the fact that some banks aren't even offering mortgages because the rate is too high. I have one bank in my home town that's not even taking applications because the rate is too high. And when someone has to pay 18 percent, plus points, to get a conventional mortgage, when the FHA mortgages are running 16, 17 percent, plus points, I don't know how anyone can afford those kinds of prices, plus the fact the average selling price of a home—I know in the Manchester area, the average is going up. It's around $70,000 now for the average. I'm sure it's even higher than that, for example, in Fairfield County. It just becomes even more of a burden, plus the fact when you add to that the vacancy rate in apartment houses are very low with condominium conversions, the fact that rents are going for $400, $500, $600 a month, I really feel very bad for that young couple starting out.

It seems to me that the Government has an obligation to these people to do something, and I'm not saying exactly what it is, but it seems to me, according to Mr. Volker, in order for him to make a move, the deficits have to be kept in line. How do we do that, Senator? I leave that up to you in the Congress, because I know you have the answer down there somewhere. I hope we just work together to try to achieve a common goal.

Senator **WEICKER.** Well, as I indicated, one of the difficulties we now have in the budget balancing formula as espoused by the President is that he, in effect, is trying to balance the entire budget with 11 percent of the budget, those programs such as education, health care, and housing. I don't think you can do that. I think defense has to take its fair share, and nobody's talking, I might add, about cutting defense. We're talking about cutting the inordinate increase granted to defense. Neither do I think you should have a tax cut of such a size that it's double your spending cut and really hasn't been earned. That's politics as usual.

Mr. Reagan wants to go on a new course, but thats politics as usual. You don't start handing out tax cuts that haven't been earned. Frederick Schultz, vice chairman of the Federal Reserve Board, indicated in his testimony in Washington—and I might indicate I disagree with this—that he thought the difficulty with housing purchases lay with the high price of houses rather than with the interest rates. What would be your comments to that?

Mr. **ZINSSER.** I think it's a little bit of each. We're finding that people, in selling their house, are not that interested in dropping their price too much. As hard as that may be to imagine, that's been our situation. People are pretty much holding out for the price that they put on the house. And the prices have gone up drastically in the last couple of years.

And then when you add to that the higher interest rates, as I indicated in my testimony, the difference between an 11-percent rate and an 18-percent rate, which we have today, is about $300 a month, and that's just in interest. I can remember when I first went in this business, that was the entire mortgage payment, including taxes.

It just cannot keep going this way, because if it is, we're really going to have a crisis on our hands. The number of housing starts are way down. There aren't enough apartments, and we're really working ourselves into a corner that's going to be hard put to turn around.

Plus the fact that Mr. Carlson, who is the economist for the National Association of Realtors, has indicated that once interest rates come down, with the great demand out there for housing, and people start going into the market, then the price of housing is going to go up even greater because supply and demand is going to come in. And then we're going to be right back to the inflation we're trying to get rid of now.

So we shouldn't be chasing our tail and getting nowhere. The rates have got to come down. I think Mr. Volker has got to cooperate in that respect. I think the President has got to look at the defense budget. Let's get on with the job and get this country moving.

Senator **WEICKER.** Carl, thank you very much. It's always good to have you.

The next witness is Donald Conrad, the executive vice president and chief financial officer of the Aetna Life & Casualty.

Don, good to see you.

STATEMENT OF DONALD G. CONRAD, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, AETNA LIFE & CASUALTY, HARTFORD, CONN.

Mr. CONRAD. Good morning, Senator. Well, I do appreciate the opportunity to offer my views on the current financial situation today. Interest rates, by historical perspective, are extraordinarily high today, and it's a most heartfelt hope of my professional life that interest rates should come down substantially and as soon as possible. The current levels of interest rates constitute a hardship for many households, businesses, and government. Maintained at these levels, interest rates are a threat to economic prosperity in the years immediately ahead. Unfortunately, however, that's the good news. The bad news is that I believe any governmental attempt to manage interest rates to lower levels will soon be proven to have been a terrible error, and that the attempt will backfire.

In my opinion, any effort to drive interest rates lower by manipulation, regulation, or legislation, will only serve to drive them higher, which is an outcome to be avoided at all costs.

I would agree with the conclusion of the New York Times editorial 2 weeks ago: "High interest rates are not the problem; they're part of the solution."

I think it's important to remember that the level of interest rates in our society is set by the mixing in financial markets the free decisions of many millions of Americans. The borrowings of some of us are financed by the savings of others among us. The financial institutions, banks, thrift institutions, investment firms, and insurance companies like Aetna Life and Casualty are intermediates in this process.

I can tell you from personal experience that American finance is currently in a state of revolution. There is no other word to describe the pace and magnitude of changes now taking place. Failure to recognize the fundamental motivation for this financial revolution is a sure way to come to grief in today's volatile financial market.

Just a few years ago, financial intermediaries of all sorts were able to gather the savings of many members of society and pass them through, as loans or investments, to other members. The functioning of financial markets and financial institutions in this efficient manner enabled economic growth to take place.

Aetna, for one, gathers the premium dollars of our customers and invests them until such time as they are needed to pay claims or to cover the costs of our doing business. Banks do the same thing with people's savings.

We used to invest these funds for a very long term. But, as interest rates have risen, the market value of those long-term investments has dropped sharply. We, and other institutional investors, have been hurt by inflation just as individuals and small businesses have been hurt, and we've all reacted in about the same way.

In other words, wherever possible, we've shortened the maturity of our assets dramatically. Individuals have put their money into money market funds, $160 billion in a few short years. And we have stopped lending for 25- and 30-year terms. We have all done everything we could to protect ourselves financially against the damage inflicted on us by inflation.

Inflation, and the fear of more inflation, have made people wise in the ways of financial risk. No longer do they seem willing to leave their savings on deposit for long periods of time or to enter into contracts that tend to tie up their financial assets. The ultimate lenders, the people, have learned the wisdoms, in current conditions, of keeping their savings in liquid form and in short maturities.

Nothing would please me more than a reversal of the current financial revolution. Lower interest rates would allow businesses to borrow without having to pass along an unacceptably high price, high costs. Lower interest rates would allow people to again be able to afford the cost of financing a house and a car.

I cannot tell you, however, that I would expect such an outcome very soon. I believe interest rates are high today as a result of millions of people, individually and collectively, acting in what they perceive to be their own best interests.

So the painful path we must take today is, in effect, the presentation of a due bill for past excesses. A high rate of interest is the market's way of telling us to slow down. People vote with their dollars just as with their ballots, and I think savers, the ultimate lenders in our society, are voting today for a return to a noninflationary economic management.

The fear of future inflation remains the single biggest cloud over the horizon. The way to change interest rates is to change people's behavior. The way to change behavior is to change beliefs. When people are confident that inflation is headed down and will stay down, then interest rates will follow as more and more dollars flow out of unproductive short-term deposits and into more productive, longer term assets which will refinance the housing industry and capital markets.

But if we try to trick them by forcing a monetary easing, then the attempt will surely fail.

I would conclude by quoting again from that New York Times editorial:

> The Fed has made some technical adjustments in recent weeks that have pushed short-term interest down a few points, but in the opinion of most analysts, if it goes much further in this direction and really pumps up the money supply, Wall Street's inflation fears might turn into genuine alarm, and long-term interest rates would head straight up.

Thank you.

Senator **Weicker.** Thank you, Don. First of all, let me get your perspective on the administration's economic game plan, at least how it contributes to our present problems and a solution.

More particularly, I'd like you to address the following mix: Spending cuts in the area of around 40-plus billion, substantial tax cuts, both individual tax cuts, and business tax cuts.

Now, I think two matters of concern that have been addressed both at this hearing and previously have been the size of the defense spending, which is immune from the cutting process, and, No. 2, whether or not the tax cut portion was earned—not the business tax, but the individual tax cut—and I'd like to have your comments on that.

Mr. **Conrad.** My views, I think, are similar to the ones you expressed before the first witness this morning. I am not a believer in the effects of the supplyside taking hold as quickly as their proponents would have them. I think the tax cut was too large to sustain the kind of economic management that I talked about bringing interest rates down. The budget is going to have to be cut more in order to do that, and I think you've put your finger on the place where it has to come from, the defense area, and there are programs in the defense budget that my understanding is nobody wants, and therefore would be simple to cut out.

But in order to get any additional cuts from any other part of the budget, I couldn't agree more the political price as well as the economic reality as to what's best to do should come out of the defense spending. But the tax cuts, which have been so large, will not sustain the kind of budget spending that we're going to see in fiscal 1982 or fiscal 1983.

Senator WEICKER. The last question, Don. I don't know what you can do about it, but, obviously, we're trying to look for some answers here. And I agree 100 percent on credit control or any sort of controls, that's not the answer. At least to this Senator. it's not the answer.

On the other hand, a company like the Aetna is going to survive this period, which is testimony to the size, the strength of the Aetna. I'm sure you fellows don't like to pay the interest rates any more than anybody else does, but you can.

Point No. 2, you have the capital and have available to you the credit to go out there and get the capital if you need it. Now, what worries me is that the small businessman—and this is what this committee is about—just can't pay the interest rate—period. He just can't get the capital—period. And the statistics I cited as to bankruptcies in these businesses are not a figment of my imagination. And I see the destruction of small business, while at the same time I continually pick up my morning newspaper and I read about one giant merger after another taking place. Before we're all through with this process, we might have inflation under control, we might have interest rates down, but it also seems to me that we will have reduced competition in this country, and in the long run, that itself will be inflationary.

Now, I just would appreciate sort of your general overview of this situation that I've described to you, because I think it's fairly accurate.

Mr. CONRAD. Well, I think it's a terrible problem, and as I said at the outset, I can't think of anything I would rather have than lower interest rates today. So I agree with that.

But I don't think that for the long term, if the economic program can be brought under control with deficits reduced and inflation reduced, that we will have the problem that you cite because of the high interest rates hurting, killing small businessmen today. It's terrible what's happening to them, but I think rather than look at a long-term reduction in competition and a long-term negative result from this, we're looking at a period of time for which the adjustment is terrible, and, unfortunately for some, it's going to mean going out of business. That's happening today.

But if we get through that period and inflation can be seen to have legitimately been brought down, and expectations for it to remain down are there, then the climate for the small businessman is going to be infinitely better than it is today, and I think it will be healthy for this country over a longer term period to have that climate so settled rather than to try to do something today to make the immediate term better, because the long term will be worse as a result.

Senator **Weicker**. Don, I know yon have a very busy schedule. I appreciate your having taken time to appear before the committee. Thank you very much.

Our next group of witnesses will be Richard Curcio of West Hartford and Sari Mangiafico.

This is a panel representing the homebuilding industry here in our State, and I'm delighted that you could be with us. Why don't you proceed in whichever way you deem appropriate?

STATEMENT OF SARI MANGIAFICO, MANGIAFICO DEVELOPMENT CORP., WETHERSFIELD, CONN.

Mr. **Mangiafico**. Senator, I'd just like to give you a perspective on the last 60 days in the marketplace through the eyes of a small builder, small businessman who, in the last 2½ years has been, literally speaking, surviving, went through his initial cuts in personnel in his own operation, and is down to bare bones, and is attempting to hold his organization together so that if and when there is an upturn, he will have the capability to put the product back together again for the consumer.

In the last 60 days, Senator, you would not believe the number of subcontractors that have come out of the woodwork. And when I say subcontractors, I'm talking about carpenters, plumbers, electricians that go from week to week to week, and that's telling you that their traditional sources of work have dried up and they are seeking work. They are seeking work, and they are not the type of people who are going to look for unemployment compensation.

From the point of view of material supplies on a regional and national level—you have companies that supply us with lumber, et cetera—they are out there searching, too. On a local level, they are coming up with prices and terms that are extraordinary. I have not seen this happen in perhaps—perhaps since the last recession of 1973–74. And you say, well, why are they doing that? They are doing that for two reasons, and I've heard this right from the front man on the line with the lumberyard. He says to me, "Sari, if we don't go out and seek out that business, our bosses are going to start cutting back personnel. People are going to be cut from the rolls. We are going to be cut back. It's going to make it more difficult for us to operate."

This is part of the toll of high interest rates. This is the impact it's having on a local level. The vast majority of businesspeople that make up the home-building product are small business people. I mean small, one-man, two-man, three-man operations. And they are devastating them. They are just dropping by the wayside.

In my own organization, I started out by hiring people from the technical schools because I found this to be a good traditional source of new people coming into the business, and having the patience to work with them, and to have them mature. Now I don't know what's going to happen to that source. I don't know whether that's being funded enough to maintain that level of flow, so that when there is

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an upturn, Senator, we're going to have the people to put the product together.

Senator WEICKER. Thank you very much. I wanted to have both of you testify, and then I'll ask the questions.

STATEMENT OF RICHARD CURCIO, WEST HARTFORD, CONN.

Mr. CURCIO. Fine. I appreciate the opportunity to speak.

I've owned or operated a small business in the West Hartford area for the better part of 15 years, both as a supplier to the building industry and as a homebuilder, and over the years, our primary source of labor has been unskilled or semi-skilled labor. We've built over 100 houses, supplied perhaps the material and labor to over 1,000 more. Presently, last year I built one. We have nobody working for us at all. And if we continue in another year of 18-percent interest rates, the biggest reason I'm here is I need a job. I wouldn't be able to.

The income that we've derived from this operation has housed many people. We've sent perhaps eight people to college, and 2 years ago we paid $44,000 in taxes just to the Federal Government, not to mention local and State governments. None of that income will be coming to the Federal Government, and how I will ever send my son to college, I have absolutely no idea.

When I first started in business about 13, 14 years ago, the biggest problem I had was competing with big business. I used to buy my material from perhaps 20, 30 independent mills on the west coast, and they would compete with each other for quality, price, terms. Today I go out and maybe there's four, Weyerhauser, a couple other big ones, and that's it. The price differential is pennies, and the quality is take it or leave it.

My biggest problem today is my biggest competitor is you, the Federal Government. I can't compete with you. I can't go into the credit market and get 18- to 20-percent loans—last year, 22-percent loans—to carry my inventory.

I had one house up last year, $12,000 in carrying charges. It's impossible to put a product on the market that people can afford when I have to pay those kinds of carrying charges.

I simply feel that it is the job of the Federal Government to maintain a free economy and maintain a free marketplace that can operate. The biggest immediate need I have right now is to—and I'm not going to argue the social differences about what programs should be cut—I don't really care anymore—I simply want the budget balanced, brought into some semblance of fiscal responsibility so that we can have interest rates that I can operate with and continue to keep my business in place.

Senator WEICKER. Well, let me ask you both this question: Let's assume the fact that interest rates go down to what has been the most optimistic prediction, 15 percent—and now I'm talking within the next 4 years, for the next 4-year period, and that's the most optimistic prediction I've seen—how do you think that's going to affect your business? Do you think that many more people are going to be buying homes under those circumstances? Where do you feel this thing has to level off before it has an impact on your industry?

Mr. MANGIAFICO. Senator, if we end up in a stabilized period of 15-percent interest rates for mortgages, what is essentially going to occur—and we've got to assume that there is going to be a stabilized market for labor and material—that is not going to begin to impact on the end product. The builder out there is going to have to come up with some creative financing in order to get people into those houses at 15 percent.

What, essentially, I'm saying is that he's going to have to continue, as part of his method of operating, like he goes out and buys lumber and buys appliances, and so forth—he's going to have to go out there and buy financing, and that's a cost of doing business. And I don't know whether that is the way to go.

Mr. CURCIO. Fifteen percent is not an adequate prime rate or borrowing rate that business can survive. Like Sari says, it's going to go right into the cost.

Senator WEICKER. I don't think it is, either. I just wanted to make it clear that's the most optimistic prediction I've heard.

Mr. CURCIO. I can tell you from my conversations with colleagues and friends who also own and operate small businesses, are small businessmen, I don't think many, if any, can survive. My interpretation is that we may see an average prime time rate of 18 percent next year, on an average, up and down for the whole year.

Senator WEICKER. I think you are probably right.

Mr. CURCIO. I don't think 50 percent of them can survive, because, don't forget, a small business doesn't borrow at the prime rate. It's prime plus one if you are really good; it's prime plus two for most.

I want to borrow $60,000—sixty thousand dollars. I will pay two points up front, I'll pay prime plus one, and the bank wants an interest reserve for 1 year set aside. In order for me to borrow $60,000, I'm probably going to have to put up close to $20,000 in an account, and you can mathematically figure out what my costs are going to me. But on $60,000, how much profit do you think I'm going to make when I'm going to end up paying to the bank maybe $18,000 with fees? I can't survive.

Senator WEICKER. Now, as I indicated to my good friend, Don Conrad, on the business scene, the fact is that a larger business could survive all this readjustment, and a small business could not.

What worries me is that the half-million-dollar priced homes will continue to sell, but that literally all of middle America is just being wiped out of the housing market.

Now, the statistics right now are that 3 percent of the people in this country can afford to buy a house. And that seems to me to fly in the face of the thousands of homes I see out here in just our State of Connecticut which certainly aren't in the half-million-dollar category. Maybe the ones that bought those homes are in good shape, but what happens to all the young people coming along who expected that they would be able to buy a home, and now, effectively, are excluded from that reality?

Is there much building going on in the middle income area in our State at this time?

Mr. MANGIAFICO. Senator, in the Manchester area—I'm going to give you a little bit of an example—we've got some condominiums started this fall. It's a very small, small project, and we're attempting to keep it in that $50,000 range.

I have talked to my traditional source of lending, who I've done business with in the last 10 years, and I just want to give some of the impact on the lending institutions. A bank that perhaps is in the category of $450 million, I am looking for $325,000 as a construction loan. I've been doing business with this bank in the past 10 years. They have done very well by me, and I've done very well by them.

And yet here is a bank with $450 million, who is hesitating about lending me $325,000. And then what I hear, the first thing I'm told is, well, with those supersaver accounts in the last 10 days, we've had $5 million that have gone in-house, obviously from other savings accounts to supersavers, and we've only had $500,000 of new money come in. OK.

So I'm saying to myself, $325,000, you've got to be kidding. And we're in a $50,000 price range per unit, and we can't find those dollars? Someone is squeezing me out.

Senator **Weicker**. Of course, Congress enacted the All-Saver Certificate to try to help the housing industry, but I think something that people have forgotten is, No. 1, the point that you raise, that the money is just turning over, and, No. 2, that this expires in 1 year's time, so who is going to go ahead and start having 20- and 25-year mortgages?

Mr. **Mangiafico**. No, they are not.

Senator **Weicker**. They are not going to. It's going to be a 1-year period. Those young people that are just starting out, are they going to go out there and hang out thin, so to speak, with all the burden on them? It's not an equitable situation with the mortgages.

Mr. **Curcio**. The cost of credit is such that it's forced, like Sari said, a number of creative financing, and I tend to chuckle at it a little bit. The largest incentive for home ownership was opportunity to build up equity, and a lot of people are not looking at what's going to happen 5 or 10 years down the line in the creative financing situation. And you wonder just what kind of equity is going to be built up in these homes over the years. Some of the programs end up with a negative equity.

What's happening is people are renting their homes from financial institutions. The whole thing becomes—I don't build in the moderate—I suppose for Connecticut, it's a moderate price range. My average home price is between $120,000 and $150,000, but I'm that to be an astronomical sum. I just recently sold a home to a gentleman that is being brought in whose company is helping him with the financing, with the interest rate differential. A $150,000 home on a conventional financing, fixed mortgage, would require a family income from him of over $110,000 a year. I mean it's laughable, absolutely laughable. I laugh at it, but it's a reality.

Senator **Weicker**. Do you have any idea, either of you, of how many of your colleagues have gone out of business within the last year?

Mr. **Curcio**. I have four, four that are totally out.

Senator **Weicker**. Four that you know that are just out?

Mr. **Curcio**. That I know. I also know two or three small business that aren't involved in the homebuilding industry that won't last over 6 months. They can't get the loans.

Mr. **Mangiafico**. Senator, we're not talking about all the builders, but all the subcontractors that you don't hear about, the one-man, two-man, three-man operation, the family operations that are the backbone, really, of the end product, that make up the quality of the product, really, from the labor end, that's going to impact on us. And we can see that out there happening every day.

Senator WEICKER. If the present set of economic circumstances continues—at the present level of interest rates, where do each of you see yourself 1 year from now?

I don't want you to give away any trade secrets, but it sounds to me like—again, I repeat, that every economic prediction we've seen indicates the situation will last for at least another 3 years. Are you going to make it for 3 years?

Mr. MANGIAFICO. Senator, I sat down with my accountant at year-end, and needless to say, I carried a very horrendous loss for the past fiscal year in my business, and my whole purpose in keeping my organization intact was that there was going to be a turnaround, and at that point in time, I did diversify to a point, and to a point, I'm honestly questioning this year coming up. I'm just taking a very conservative—conservative tact on it—and saying to myself, "Do you think that things will get better?" And don't look at it as if there is something there, look at it as if nothing's going to happen and retrench. That's essentially it.

Mr. CURCIO. I feel exactly the same way. I guess probably what will happen is I'll get a job. I feel I have the financial wherewithal to withstand several years, but I don't think I have the mental attitude to be put out of business by forces that seem to be way beyond my control. I don't think you or anybody that I know that's active wants to sit around and twiddle their thumbs.

Senator WEICKER. What worries me—and we'll get to this with my friends from the Association of Realtors—but what worries me in all this is as each of you small businesses drop out, we're going to end up having large corporations in the homebuilding field.

Mr. MANGIAFICO. You have it now.

Senator WEICKER. Well, I agree with you, we already have it, but I mean on an ever-increasing basis. And I think what's interesting in the testimony, Richard, that you gave, where you said there was a time when you could go out and get your supplies from a dozen or so suppliers, and now they have dwindled down to four, and there's almost no price differential at all. So, if indeed you fellows drop out and it comes down to a half-dozen or so corporate builders in the United States, it seems to me the public suffers on that account very clearly. But, could this happen in your industry?

Mr. MANGIAFICO. Yes, it could.

Mr. CURCIO. It will happen, more than likely. To be perfectly blunt on it, I think we've gone beyond the point of no return. I don't foresee a turnaround in the housing industry, and I don't foresee a turnaround for small businesses, period. I think that the mistakes that were made by past Congresses and past administrations were so great that the length of time it's going to take to redo them is out beyond the return of the businessman.

Mr. MANGIAFICO. Senator, I tell you, these are extraordinary times. They really are. We're doing things that I never would have conceived of doing 2 years ago or 3 years ago, and as I perceive it in Washington, I say, my God, our representatives have to realize that these are extraordinary times which require extraordinary decisions, and with some viable alternatives. That, to me, is the bottom line of it, the viable alternatives.

Here we have an administration, we're saying look, this is the line, this is the tact we want to take, and yet we're not getting the viable alternative from our legislature, at least I don't perceive it—and I'm not that close to it—but, on the other hand, from what I read and see and hear, it just doesn't seem like they are ready to take the tact that it requires extraordinary decisions in very, very difficult times.

Senator WEICKER. I think one of the difficulties is that as much input as some of us try to have, the administration is just hellbent to do it——

Mr. MANGIAFICO. Their way.

Senator WEICKER [continuing]. Their way. Now, let me point out some specific examples. I've already indicated I thought that the individual tax cut at this time was just devastating in that it would make it impossible to quickly balance this budget, which is what you feel is necessary and I feel is necessary.

You add the loss of revenue to the total unchecked defense spending, and, believe me, you are going to have a bigger deficit next year and the year after. Now, all of us live in a State that's very closely allied with the defense industry, and nobody is arguing that they shouldn't have a goodly share of the Federal budget, but I think it's just as important in the State of Connecticut that homes are built, that kids can go to school. I go right on down this checklist that that's just as important to us as the defense industry.

And yet what's happening right now is all these other areas are being dried up, and we're going to end up with—I'll tell you what we're going to end up with: United Technologies and Electric Boat, and some of the allied industries to that, and nobody with a roof over their head or an education.

You talk about the cuts, you say you get many of your workers from the technical schools. I've got news for you. That money was just slashed all to hell.

Now, I don't think that that's misdirected Federal spending. That's Federal spending that comes back manifold. These children come out of that school, they work for you, they start earning money, they pay their taxes, et cetera. We get back manifold what we invested in that initial education in that technical school.

Point 2, on the tax cut side, it was my amendment, albeit small, that specifically cut the corporate tax rate in the lowest two brackets, and we had to fight like heck to even get that.

I suppose what I'm saying is that I look on this economic game plan—I have no argument with the result to be achieved—but my feeling is that we all share the burden, big business with little business, the big guy with the little guy. And right now I see the little guy and the little business, in effect, taking the medicine for the whole country. There is the problem.

Mr. CURCIO. Can I ask you one thing? What scares me from where I'm sitting is that I see all the different political persuasions arguing back and forth over the merits of this budget cut or this tax cut back and forth. Nobody seems to say that the goals are unrealistic or improper. And yet I am very much afraid that the political debate that goes on will be so intense and so long and drawn out that we won't reach the goal, that we will sit there and argue about the merits of this tax cut or this social program and not get to the immediate goal that allows us to have a balanced economy, and we're almost at the point where we say do whatever you have to do, but give us a balanced economy.

Senator WEICKER. I have to confess to you the problem with that attitude is exactly what gave the administration its entire economic game plan without any adjustment whatsoever, and that's one of the problems we have right now, that gave the tax cut right away, which now everybody agrees was a mistake. I realize you need assistance right now. Nobody appreciates it more than I do. I would say, in the next couple of months, you are going to have a basic battle waged on two of the fronts we're discussing here, both the defense cuts and a delay of the tax cut. So I don't think we're talking about something that's going to be a long time in coming.

In the meantime, I've got to say to you that I personally am unwilling to see a situation continue for 3 to 4 years of your not being able to build homes and other people not being able to buy them. I am not willing to accept that. Some remedy is required.

Thank you, gentlemen. Thank you very much for taking your time to come. I appreciate it.

Our next witness is Miss Elizabeth Pattee, president of the Connecticut Association of Realtors. Good morning, and welcome. I figure if they are not building, you can't be selling.

STATEMENT OF ELIZABETH C. PATTEE, PRESIDENT, CONNECTICUT ASSOCIATION OF REALTORS, HARTFORD, CONN.

Ms. PATTEE. Absolutely. I will say, Senator, though, I discovered something this morning. I can understand why so many of the bills passed in the Senate have great difficulty being interpreted or always understood. The acoustics are so bad here that if I'm repetitive of what the people have said beforehand, it's because we really can't hear them too well.

You do know that there hasn't been building, and, therefore, if we don't have building, we can't be selling houses. We have 10,000 realtors and realtor associates in the State of Connecticut, and I would say, by and large, most of us are small businessmen and businesswomen. We're involved in all phases of the real estate business, but primarily in the sale of existing homes.

The real estate transaction process has declined, and we have statistics from the "Commercial Record." In 1979, there were 69,368 transactions; in 1980, 52,925; and in the first half of 1981, 23,757.

Senator WEICKER. Could you repeat those for me?

Ms. PATTEE. Yes. In 1979, there were 69,368 transactions; in 1980, there were 52,925; in the first half of 1981, there were 23,757.

Dollar decline between 1979 and 1980 was nearly $800 million. Percentagewise, existing homes in Connecticut declined 24.1 percent. That is, from 35,000 units in 1979 to 26,600 in 1980. Private housing starts, as you have heard, have dropped—and I didn't get the figures—but our figures show that 13,800 in 1979 down to 9,800 in 1980.

You notice what I'm saying, Senator. It wasn't just this past year. It wasn't even the year before. Actually, many of us never recovered from 1974, 1975, 1976. It's like the patient who has a drastic illness—they never got a chance to get better before they caught something else, and that's what's been happening here. We thought it was about as tough as it could get in 1974, 1975 and 1976. Then we had a pretty good 1977. We began to think we might breathe again in 1978 and the beginning of 1979. Toward the end, it was all gone again.

I think they've already said all of the related businesses and all of the impact of the dollars that go with the sales. I'm not going to go into all of those today, but I would rather like, if possible, to bring this committee back to one small existence.

I've been in the real estate business for 25 years. I'm what they call a single parent with seven children. I have been able to raise them—they are on their own—by running a business. What happens when I go out of business?

I'm reaching the age when I would like to retire. The money that I would have had so that I could have safely retired and not had to go live with one of my children in 5 years has gone to support the business that is rapidly going out of business.

Two years ago, I had been reduced to 2 offices and 18 sales people. Today, I'm reduced to one office and six sales people. Most of them have either gone into other businesses or are looking for work.

Interest rates are taking us right out of the American dream. Everybody talks about the American dream, own your own house. How about just finding a place to live?

I have a son—I have several sons and daughters—but the youngest ones, I don't know when they will ever be able to buy a house. It's like when somebody comes into my office from one of the lending groups to tell me the marvelous news that VA for our veterans has dropped a little bit—it's only 17½ percent, and 5 points to the seller and 1 to the buyer. Isn't that wonderful?

Well, if you take your little interest rate book and try to find a house, first of all, at $50,000—take an average of 60—at 100-percent mortgaging, and find out what that veteran could possibly pay at 17½ percent, he's not going to have a house. That's definite.

Senator WEICKER. What does he pay? I'd like to figure that out as to a $50,000 house and about 18 percent interest.

Ms. PATTEE. I was just going to say I'm reasonably sure—I don't have an interest rate table with me, but I'll tell you, between his mortgage payment, principal and interest, and his taxes and insurance, he's going to be very close to $1,000 a month if you are talking about a $60,000 house. It's impossible. Even bankers—I have a son who is a banker. I think he makes $238 a week. You know, if you figure that out, Senator, three is no way he's going to even save any money in order to buy a house with the interest rates at what they are.

[Subsequent information was received and follows:]

GREATER MIDDLETOWN BOARD OF REALTORS, INC.
363 MAIN STREET
MIDDLETOWN, CONNECTICUT

October 1, 1981

MLS ACCUMULATIVE MONTHLY STATISTICAL REPORT
MONTH OF SEPTEMBER - - - - 1981

	SEPTEMBER 1981	1st 9 MONTHS 1981	1st 9 MONTHS 1980	% CHANGE
NEW LISTINGS	138	1194	1128	+5.9
NUMBER OF SALES	30	303	345	-12.2
RATIO OF SALES TO NEW LISTINGS	21.7	25.4	30.6	
NUMBER OF CO-BROKES	13	135	167	-19.2
RATIO OF CO-BROKES TO SALES	43.3	44.6	48.4	
RATIO OF SELLING PRICE TO ASKING PRICE	92.8	94.8	94.0	
PLACED ON DEPOSIT (Sept.1980)	42	375	568	-34.0
EXPIRED	90	568	508	-10.6
RATIO OF EXPIRED TO NEW LISTINGS	65.2	47.6	61.8	
DOLLAR VOLUME ALL SALES*	$2,021,600	$18,696,891.	$19,794,925.	-5.5
DOLLAR VOLUME RESIDENTIAL ONLY**	$1,699,600.	$15,573,391.	$17,045,805.	-8.6
AVERAGE PRICE	$67,254.	($66,269.)	$60,661.	+9.2

THERE ARE 500 ACTIVE LISTINGS (+2.7%)
1980 487 ACTIVE LISTINGS

NOTE*DOLLAR VOLUME ALL SALES REPRESENTS SALES OF ALL TYPES OF PROPERTY.
**DOLLAR VOLUME RESIDENTIAL ONLY REPRESENTS SINGLE FAMILY RESIDENCE ONLY.

Average Sale Price - 1st 9 mo's 1979 - $56,884.
1980 - $60,661.
1981 - 66,269.

1st Mtg - $55,000 @ 18% - 30 yrs
Monthly pmt - $828.90 (P & I)
$900 yearly taxes 75.00 (mo. Tax part)
240 yr. Insurance 20.00 " ins part
$923.90 per month

Average 3 pts for Mtg to be paid at closing
$1650.00

GREATER MIDDLETOWN BOARD OF REALTORS, INC.
363 MAIN STREET
MIDDLETOWN, CONNECTICUT

October 1, 1980

MLS ACCUMULATIVE MONTHLY STATISTICAL REPORT
MONTH OF SEPTEMBER - 1980

	SEPTEMBER 1980	1st 9 MONTHS 1980	1st 9 MONTHS 1979	% CHANGE
NEW LISTINGS	131	1128	1195	-5.6%
NUMBER OF SALES	50	345	518	-33.4
RATIO OF SALES TO NEW LISTINGS	38.2	30.6	43.3	
NUMBER OF CO-BROKES	24	167	257	-35.0
RATIO OF CO-BROKES TO SALES	48	48.4	49.6	
RATIO OF SELLING PRICE TO ASKING PRICE	95.6	94	95.5	
IN PROCESS (ON DEPOSIT)	74	506	675	
EXPIRED	81	508	407	+24.8
RATIO OF EXPIRED TO NEW LISTINGS	61.8	45.0	34.1	
DOLLAR VOLUME ALL SALES*	$2,803,450.	$19,794,925.	$26,401,860.	-25.0
DOLLAR VOLUME RESIDENTIAL ONLY**	$2,212,550.	$17,045,805.	$23,208,735.	-26.5
AVERAGE PRICE (RESIDENTIAL - SINGLE FAMILY)	55,314.	$60,661.	$56,884.	+6.7

THERE ARE 420 ACTIVE LISTINGS
1979 - - - 487 ACTIVE LISTINGS

NOTE* DOLLAR VOLUME ALL SALES REPRESENTS SALES OF ALL TYPES OF PROPERTY.
**DOLLAR VOLUME RESIDENTIAL ONLY REPRESENTS SINGLE FAMILY RESIDENCE ONLY.

Ms. **Pattee**. Again, because I have not heard everybody and exactly what they have said, I would offer you a couple of things that I would like to see happen in Connecticut. Before I do that, I would like to mention, though, I've had a couple of letters from the Federal Reserve Board of Governors, and, of course, they keep telling me that the way we're going to defeat this high inflation is to bring prices down. I will tell you, the prices of houses have not come down and are not coming down.

I think I was in seventh or eighth grade when I had a lesson in the law of supply and demand, and if the supply is short and the demand is high, you are going to have higher prices. You will say, well, if you can't sell any houses, how can you say the demand is high? It is high. People are just waiting so that the minute the interest rates come down, they have to have housing. They are going to jump in, and there isn't going to be enough, and it's going to shoot the price up again.

But I did hear one of the gentlemen mention that prices have come down. I can give you those statistics in Middlesex County. Middlesex County, in 1979, the average price was $56,884. That was the average price for the first 9 months of 1979. The average price for the first 9 months of 1980 was $60,661. The average price for the first 9 months of 1981 is $66,269.

I'm not talking about houses down in Fairfield County where we have $400,000 houses bought for all cash. I'm talking about people who pay 60, 65. But the prices of houses are not coming down, added to the interest rate not coming down. Then, of course, nothing is moving. Then the real estate people are going to be out of business, and many of them are.

Our membership here in the State of Connecticut in the Realtor Association has dropped about 4 percent, and I hold my breath. I would not like to see the statistics for next year.

One of the things that I think in a small way helps, is our Yankee Mac program, which has utilized the State employees' and teachers' pension fund--I'm not sure just what the law is, but I would like to see that law changed which inhibits private pension funds from going into residential mortgages.

I realize that when the law was first in effect, it was because the legislature didn't feel residential mortgaging was a good investment. I personally will tell you that if you could afford it, it's the best investment you could possibly make. Therefore, I feel it is a good investment, and I would like to see that happen.

The other thing I would like to see happen—my belief is that the All-Savers certificate program, 75 percent was intended to help the housing market, not to bail out the savings and loan. I thought that was the intention. I would like, some way, to be sure that that money does go back into the mortgage market for the people, not just to pay higher interest rates or certificates or whatever.

That's my story, sir.

Senator **Weicker**. Well, I think you have phrased your story in very eloquent terms. You know, what bothers me is the great stability, the political stability of this Nation as compared to other democratic societies, whether in Italy or England or wherever. The great stability of this Nation has been in the fact that a great number, if not a majority, of our citizens had a piece of the action, and more often than not, that was defined in terms of owning a home. You have effectively, at this stage of the game, excluded 97 percent of the country from owning a home. I'm not talking about those who have already bought their homes, I'm talking about those who are coming along and would like to buy a home. And it seems to me we have all sorts of problems that are going to arise out of that before very long. Frankly, I just don't think any government policy that totally wipes out a new generation of Americans from owning its own homes is a wise policy. I do not.

Ms. PATTEE. I would say one other thing, and it was mentioned briefly. Under the circumstances, the economic picture as it is now, it is true, business will get bigger and all of the small ones will go by the wayside. They can't survive.

Senator WEICKER. I'm glad you raised that, because I had forgotten. I should have particularly asked you. Especially in your field, haven't the big fellows been moving in and no longer do you find small operations like yours? They are all being sucked in by fairly large corporations, and now even those large ones are being bought by larger ones.

Ms. PATTEE. Exactly.

Senator WEICKER. I used to think there was something extraordinary about Caldwell Banker acquiring small real estate firms, and now I find Caldwell Banker being acquired by Sears, Roebuck, so it really means to me, in the long run, diminished competition, and in the long run, that will be very inflationary for the consumer.

Do we have much of this in Connecticut, by the way, that is, real estate agencies being bought up by larger entities?

Ms. PATTEE. It is being done. It is on the way, and I know now it's just going to snowball, and it's going to be more so, again, because the small independents—and I use that word with—you notice I smile. I like that word "independent," and I feel we're losing that independence, the office that works in the small community, everybody knows each other. It sounds kind of corny, but it's very solid. We pay the property taxes, we own our houses, we send our children to school, public school. We participate. I honestly see it, Senator, going right down the tube.

Senator WEICKER. In the State of Connecticut, for example, did Caldwell Banker ever buy real estate firms here in the State?

Ms. PATTEE. It has not at this point. We certainly expect to see it happen.

Senator WEICKER. What about Merrill Lynch?

Ms. PATTEE. Yes, Merrill Lynch has, of course, taken over a rather large section of the State from New Haven northeast. The only area that they are not in with Merrill Lynch is in the Fairfield County area.

Senator WEICKER. I have nothing against the free enterprise system working, except where the circumstances are forced upon it by an economic policy such as we've been engaging in for the past several years. You are correct; it's not a problem of the last several months. It's been a problem we have been living with, and in essence, it has been, for the real estate firms, the real estate market, that unless the agents could also provide the financing——

Ms. PATTEE. That's right.

Senator WEICKER [continuing]. The customer had to go elsewhere, and these larger corporations, obviously, have the capital. As I indicated to Don Conrad, they have the capital available to them so that they can make the loans.

Ms. Pattee. And they can keep it all moving, whereas the smaller person is dependent upon the others and on banks and so forth, and on the government, and they can't keep it moving.

Senator Weicker. I thank you very much.

Ms. Pattee. Thank you for having us. We appreciate it.

Senator Weicker. We now move on to the retailers panel, Pauline Israelite of the Norwich Town Mall Book Store, Mr. James Shapiro of Shapiro's of Middletown, and Mr. Michael Prisco of Prisco Electric Appliance, New Haven, Conn.

Good morning, everybody. Sit down and make yourselves comfortable. We're delighted to have all of you here before the committee, and you can proceed in any way that you wish.

Mr. Prisco. We haven't arranged anything, Senator. We never met before.

Ms. Israelite. Would you like me to speak?

Senator Weicker. Why don't you go right ahead?

STATEMENT OF PAULINE ISRAELITE, NORWICH TOWN MALL BOOK STORE, NORWICH, CONN.

Ms. Israelite. I am the owner of a fairly new business in the Norwich Town Mall in Norwich, a retail book and record shop, and I think that the problem with me and high interest rates is a matter of just surviving.

When I borrowed money to go into business 5 years ago, I borrowed at the prime rate which was about 8¼ percent, and as of Friday, it was 19.

I also have to compete in my business with the large chain stores, and in order to compete, I must maintain a large inventory. I must be able to buy in large quantities so that I can obtain good discounts. In order to do this, I was relying on short-term bank loans. I am not able to do that anymore, because in order for me to borrow money, I can no longer make money. And that, in essence, is the story of my survival.

Senator Weicker. In other words, your principal problem here is a matter of interest rates? The capital you could probably get, but at an inordinately high interest rate?

Ms. Israelite. Exactly.

Senator Weicker. And you find it difficult, probably, to pass that along to your customer?

Ms. Israelite. I can't pass it along. I'm in a business which already has an item which is premarked before I can sell it. A book has already a fixed price, so I have no place within that price, so that what you find is that your margin just gets smaller and smaller until you can no longer afford to borrow money. And it's just—as I see it, just a matter of survival for small business.

Senator Weicker. Either that or we're going to end up with nothing but Doubleday and Brentano's bookstores all over the country.

I think one thing that becomes very clear here is that this is an economic policy geared for the big. It's just brutal on the small.

Why don't we just keep on going, then I might have some general questions for all of you.

Mr. Michael Prisco.

STATEMENT OF MICHAEL PRISCO, PRISCO ELECTRIC APPLIANCE, NEW HAVEN, CONN.

Mr. Prisco. Senator, I manage a family-owned television and major appliance store that's been in the New Haven area for some 27 years now, and like my friend to my left here, we do have problems financing inventories. In our case, it's probably a little bit larger than hers, because the inventory would be a little heavier, the types of items that we sell, major appliances and televisions.

However, there is another issue besides inventory financing that I want to address today, and that's the issue of securing financing for the customers who come into our store that cannot pay cash for their purchases. The issue is increasingly—it's increasingly difficult to get financing for our customers that come in for these so-called big ticket items. Traditionally, in order to finance the purchases, we've used basically two methods. Years ago, we used to have what we'd call an inhouse financing or open accounts on our own books, and, of course, this necessitated carrying large amounts of dollars on our accounts receivables.

Today that practice is all but nonexistent in our type of business for a couple of reasons, one of which is you need an incredible amount of capital to be able to finance large accounts receivable, and today you cannot afford to go out and borrow money, and probably charge the customer less than what you've actually borrowed the money for in the first place, which brings me to the second vehicle that we've used to finance short-term obligations for purchases of this kind. And that's arranging some kind of setup with finance companies or other banking institutions.

A typical example is a customer comes into the store, we have him fill out a credit application, we call in the information to the credit company or finance company, they make a credit check, and they either approve it or disapprove the application.

But right now in Connecticut, the majority of finance companies will not accept any type of what we call retail installment contracts. Retail installment contracts apparently fall under specific guidelines and regulations within our State, and there has been a ceiling set on interest rates which finance companies can levy on the borrower.

Senator Weicker. What is that in Connecticut?

Mr. Prisco. Well, it has been 18 percent up until this July. Connecticut raised it to 21 percent in hopes that it would alleviate part of the problem. So far, it hasn't really changed the picture at all. Finance companies are still—the majority of finance companies are not willing to do business in the State and write these kind of sales contract agreements.

Certain finance companies won't write any retail contracts. The few that do are now currently charging back to the retailer what they refer to as a discount rate or a set of points. In order for them to take the paper, the retailer must pay a certain number of points that has been as high as 7 to 8 percent of the unpaid balance which the customer is borrowing. So if a customer comes into my store and wants to finance $500 for the purchase of a refrigerator, I would have to pay to the finance companies as much as 7, 8 percent in order for them to accept the paper.

At this particular time, as expensive as that may be, there have been many retailers who are willing to pay those points in order to, you know, grab ahold of the sale.

Senator **Weicker.** So are you telling me that the finance company, in effect, is getting somewhere around 25 percent?

Mr. **Prisco.** In those instances. In those instances.

There are several problems that this would create. First of all, the retailer has no financing. A person could not even find a company to take the paper without points. Second, if he has a financing company, he can absorb the points, but it raises the cost of doing business. For people who rely on this type of financing for up to 50 percent of their sales, this is devastating. Third, they can pass the cost on to the consumer, but that would be very difficult, and it would be very difficult to handle on the sales floor. You are going to be quoting different prices to someone who pays cash or someone who wants a year financing. That can be pretty cumbersome. These are the consequences, I think, to the small businessmen.

On the other hand, you have consequences to the consumer. I realize a lot of consumer activists would oppose any type of raising interest rates, thinking that it's for the good of the consumer to keep the interest rates in these instances as low as possible, and ordinarily I would agree, but they have to consider is that you have basically two choices: Either you have interest rates which the finance companies can live with, or a great many consumers aren't going to be able to make purchases at all.

So it's a choice between being able to buy certain goods or not being able to buy them because you don't have the proper credit. So it's a consumer problem as much as it affects the small businessman today.

Senator **Weicker.** Now, you sell what would be termed as big ticket items in home appliances, iceboxes, and stoves?

Mr. **Prisco.** Right.

Senator **Weicker.** What's been happening in that market?

Mr. **Prisco.** As far as how good is business, do you mean?

Senator **Weicker.** Yes.

Mr. **Prisco.** At best, we would have a flat year now. Considering inflation, we would be behind. Gross profits would be down considerably.

Senator **Weicker.** Aren't you also going to be impacted insofar as the lack of home building that's going on?

Mr. **Prisco.** Somewhat, but at retail level—builders are able to get deals on the outside. They don't always have to come to retailers to outfit the homes that they are building. It's not that big an issue to me at this point, the lack of homes being built, except for the customer who may be a customer of our store anyway buying a new home or building a new home, and they would want new appliances. In that regard, I think it would affect us more than dealing directly with builders.

Senator **Weicker.** Mr. Shapiro?

STATEMENT OF JAMES SHAPIRO, SHAPIRO'S, MIDDLETOWN, CONN.

Mr. **Shapiro.** Thank you. I will be brief and to the point and try not to repeat too much.

I am James Shapiro. I help to run an 81-year-old family business in Middletown. It began 81 years ago as a small drygoods store.

Looking at the problems of high interest rates, causes, consequences, and outlook, I have to start with how we are affected, first of all.

Borrowing is the first thing. Our inventory is our business, so, thus, we have to borrow, but we are limited because the extra expense must come out of somewhere. Does it come out of profits or is it passed on to the consumer? Some retail prices must go up, others cannot, as Pauline mentioned, due to fairness to the consumer. Thus, the retailer loses out.

The consumer is also affected by increased interest rates. For about 7 years, we had our own charge accounts, and just 2 years ago we did go to a bank system. The customer, however, is paying much higher interest to the bank, where we had not charged higher before.

We are also affected by lack of funds for improving our facilities. We are in an old building, and we strive to make it look right and make it comfortable to the consumer. Due to higher interest rates, we cannot improve it as much as we'd like to, as we have in the past.

Looking at the outlook, once again—not to repeat too much—my opinion, first of all, is—and this is not maliciously meant toward you—any business begun 5 years ago or less, I'm afraid will be out in 3 years.

Our business is very good, I'm happy to say, and maybe it's because we're in central Connecticut and unemployment is not as great in that part of the area as it is in other parts of the State, but it has ceased to be as profitable as in the past.

I think Government must begin to look at more ways to help small businessmen prosper. I mean the middle-of-the-road, established business with long history and established credit. They should be given some kind of break such as discounts on loans or more tax breaks besides.

I'm afraid that the small businessman who comes in just because he thinks that he can do it on *x* amount of capital, and it is not enough capital, can hurt the whole economy in general. And, in a nutshell, that's the way I feel.

Senator WEICKER. Now, all of you are small business-persons and residents of this State, and, obviously, you are interested in what's going on as citizens of the United States, and just for a minute I'd like to get each of your individual views. I realize you are not professional economists, but you obviously have your own opinions as to this economic game plan and whether it's titled in one direction or another.

I just would like to hear from you as to what you think or what you'd like to see done that isn't being done, and just give me—here is a couple of minutes to sound off in front of a U.S. Senator, and please go ahead. I'd like to hear those views.

Mr. SHAPIRO. I can just start and say, unfortunately, it's 1981—I have to be optimistic and say let's hope it will get better.

I'm afraid the one who really suffers is the consumer, because they end up paying more. As Mrs. Pattee said before, real estate has just gotten out of hand completely. The cost of goods as far as clothing and appliances is going higher and higher, and how do they finance it unless they've got money saved in the bank? How does a 25-year-old couple married for 2 years go out and buy a house, and buy a TV, and eventually have a child in this day and age? They are the ones I feel sorry for, I am afraid.

And I have to be honest and say that the luck that we have is that we have an 81-year-old business and we have tradition behind us, we have a following, so we will struggle through this economic hard time. It's the younger consumer who I feel for, who is really getting it on the chin not being able to have the things, as you mentioned before, that the American dream provided 10 or 15 years ago.

Senator Weicker. Anything else?

Ms. Israelite. I think, in essence, that's really the story.

Mr. Prisco. I would have to agree with what he says. Basically, we're in a similar situation. I think that we will probably, short of catastrophe, be able to persevere through the economic struggles that we're in now, but it's just so difficult for people to be able to buy the things that they need today. In many instances, Senator, we're not talking about luxury items, we're talking about so-called necessities in a household.

Mr. Shapiro. A TV is a necessity these days.

Mr. Prisco. I'm not talking about the second set for the bedroom, but a family needs refrigeration equipment, stoves to cook on, et cetera.

Senator Weicker. Let me say this: That as I see the full manifestation of this economic policy, I see things getting much worse. We haven't started on it yet.

Mr. Shapiro. For the consumer.

Senator Weicker. For the consumer.

Mr. Shapiro. But we will survive as businessmen.

Ms. Israelite. We may or may not.

Senator Weicker. As you have said—you have been very candid saying you are an established, old business, and you feel you can weather it, but, of course, the statistics are staggering as to the number that are going under. And I might add that we're not talking about fly-by-night operations here, we're talking about people who have had their lives invested in a very steady and sound way in a small business just being unable to go ahead and obtain capital or to pay the interest to obtain capital.

I think a good legislator doesn't just react to a policy, he tries to anticipate and ameliorate or modify the effects of that policy. I've been yelling about housing—as my friends in the housing industry will tell you, I've been yelling for about 3 years now in this business of housing, and for that reason I have a very good communication with the homebuilders, because they realize I'm not hopping on a political bandwagon. I could see it coming over the years. I'm telling you if the Government persists in this economic policy that accentuates defense to the exclusion of everything else, which plays the old game of politics, of giving people tax cuts when those tax cuts have not been earned, I don't see anything but the deficits widening, the Government going into the market to borrow the money to cover the deficits, and the interest rates continuing to soar.

I have deep concerns over the policy as it now stands, and maybe there will be some modifications in the areas that need it most. I would certainly hope so.

I don't want Connecticut's economy based solely on what the residents of Greenwich and Darien, and New Canaan can afford. And we very well might be getting to that point. I have no criticisms at all of those who have earned money and made money--God bless them all—but I want to make sure that the marketplace continues to expand by virtue of people continually coming up and playing a role in it, and that's what worries me right now, because it seems that effectively has been cut off. In other words, I'm saying you are going to have the same customers today that you are going to have tomorrow, that you are going to have next week, that you are going to have next year. That's not a growth country.

Thank you very much for taking your time to be with us today. I very much appreciate it.

Why don't we just recess for about 10 minutes here?

[The hearing recessed at 10:45 a.m., and reconvened at 11:05 a.m.]

Senator WEICKER. We have, our next witness, Mr. Richard Wagner, president of the Connecticut Automobile Dealers Association. Dick, it's good to have you. The floor is yours.

STATEMENT OF RICHARD D. WAGNER, PRESIDENT, CONNECTICUT AUTOMOBILE DEALERS ASSOCIATION, WAGNER FORD-DATSUN-PEUGEOT, SIMSBURY, CONN.

Mr. WAGNER. Thank you, Senator.

My name is Richard D. Wagner and I am a Ford-Datsun-Peugeot dealer from Simsbury, Conn., and a director of the Connecticut Automotive Trades Association and a director representing the State of Connecticut to the National Automobile Dealers Association. Allow me first to take this opportunity to express my sincere appreciation for the invitation to testify before you today as to the effect of high interest rates on the Connecticut retail automobile industry.

You have already received testimony from our National Auto Dealer Association on the devastating impact of high interest rates on the retail auto industry on a national basis. This testimony, given by Vice President George Lyles on September 24, 1981, in Washington, is still valid. The automobile industry is still in the midst of a deep and severe depression. Domestic vehicle sales are the lowest since 1961. Small business dealer attrition rate is staggering.

In Connecticut there has been almost a 10-percent dealer loss which does not reflect dealer consolidations or replaced out-of-business dealers. The future is even more alarming. Many dealers are hanging on by their fingernails. One group of dealers with a prominent franchise, representing probably the highest volume of sales in the State, reports 65 percent of its dealers in the red year-to-date. That, coupled with the less than 0.06-percent profit before tax on total dealership sales nationally, point out the critical condition of dealers.

There has been a large loss of jobs in the Connecticut retail auto industry. This loss is not only from dealers going out of business but also from the existing dealers tightening their belts. Also, the remaining dealers are forced to hold down wages to below prevailing rates which forces additional skilled people from our industry. We now have not only tragic high unemployment by our nonskilled workers, but also a loss of high-skilled people even more needed to service our increasingly difficult advanced technology vehicles. Our State's average dealership employee is down to an average of $6.65 per hour. Compare this rate to figures we hear in the news and it's the amount per hour that most other industry workers are asking as a raise. The retail auto industry is essential to our society in Connecticut, especially where mass transportation is lacking. Without our skilled technicians, our consumers are not going to be able to have their vehicles adequately serviced.

The high interest rates appear to be the major contributing factor to this disastrous condition of the retail automobile business in Connecticut. The State retail installment turndown rate for willing buyers of vehicles is a little below the national 30-percent figure. This is because in this State we have recourse to the dealer financing agreements by the banks and finance companies. Banks and finance companies merely charge back to the dealer in the event of customer payment default. Even with that security blanket, the banks have deserted dealer financing programs to the extent that there now is only one bank still active. The bankers of Connecticut have found more attractive areas of investment with higher yields. In the event they do any auto financing, they loan directly to the consumer at a higher rate as the banks of Connecticut are exempt from the State usury laws. With one bank and the captive finance companies left to handle retail financing, competition is decidedly reduced.

Another problem accentuated by this lack of competition in financing is the availability of money for dealers to floor plan their inventories. Since only 3 of the 24 manufacturers of automobiles have captive finance companies, the rest of the dealers are many times unable to find money sources even at the exorbitant rate of 2 or 3 points over prime.

To examine other areas for causes of our small businessmen's auto dealer plight, we naturally turn to vehicle prices. It would be naive not to say they are contributory. However, a quick review of vehicle prices show they are not out of sync with the rest of the goods and services required by our citizens. In 1960, the family median income was $5,620; the average new car cost $2,920, resulting in a 6.2 months' income required to purchase a new car.

In 1981, the median family income was $22,650; the average new-car price is $8,220, requiring 4.3 months of income to purchase a new car. In addition, new-car prices are rising at a slower rate than both median family income and the Consumer Price Index. For example, since 1967, new-car sticker prices have risen 84 percent. But, over the same period, the Consumer Price Index has risen 150 percent. Trade-in values for used cars are also rising, up 8.8 percent from 1978 to 1979 alone. This year's figures are not available, but percentages as high as 15 percent are being forecasted.

As a small businessman, I do not have the knowledge or information necessary to devise a plan to correct this economic disaster. You gentlemen are elected by our citizens to help us. I do hope you can effect a resolution to this high interest rate problem. If you don't or can't in the very near future, there will be severe permanent damage done to the automobile industry. The ultimate loser, however, will be the consumer, who will only be able to purchase his car from a few servicing dealers at very uncompetitive prices. The consumer will be unable to get adequate service for his or her vehicle and at drastically disproportionate costs to the value received.

In conclusion, the dealers cannot survive these high interest rates much longer. Immediate relief is needed; not necessarily a drastic reduction of rates is sought, but some significant relief.

Mr. Chairman, I sincerely appreciate this opportunity to appear before this committee today. I will be happy to attempt to answer any questions you or other members of your committee have regarding my remarks concerning the impact of high interest rates on the retail automobile industry in Connecticut.

Thank you.

Senator WEICKER. Thank you very much, Dick. I don't see any forecast that's been presented to me, nor do I see, as a matter of my own opinion, based on the President's economic game plan, any diminution of interest rates below the 15-percent level. And what I worry about was that here the great emphasis for a long time was that we weren't building the right cars in this country, we need them smaller, more fuel efficient, et cetera, and now we're going to have them, and nobody will be able to afford to buy them.

The only thing I would suggest is that sure, I represent the State of Connecticut, but I'm subject to all the majorities that everybody else is subjected to down in Washington, and possibly a voice is needed by the small businessman who, with the exception of the corporate tax reduction that I introduced into the President's tax bill, was totally excluded from this economic policy. If, indeed, we have to have an economic policy and there is a price to be paid, everybody has to pay it, not just a handful.

I think the homebuilders, the automobile dealers, are just bearing a terrible burden in this game plan.

Mr. WAGNER. I think we are bearing a disproportionate share of the burden, and I think that our industry is particularly neglected. The home builders, of course, have their All-Savers Certificates. We have nothing directed at our industry, not that we're looking for a handout. We're certainly not. But I do think that the industry should have some consideration.

When you speak of a reduction to 15 percent, if we could see that on the wholesale end, I think that would be almost a bearable level. But when you are talking 20, 21, and 22 percent money that a dealer has to pay for his floorplan, it's just unbearable, and it forces the condition I pointed out where by your banks leave the automobile industry deserted because they don't, first of all, want to have to loan money out at the cap rates in our State, and they do see more profitable areas, so it does lessen the competition. When you have lessened competition, it does mean higher prices for consumers.

Senator WEICKER. I notice you are a Ford-Datsun dealer. Doesn't this present to you two situations? This was touched upon by the president of your national association when he testified, the fact that the Ford Motor Co. does have a financing plan, don't they, like GMAC or whatever?

Mr. WAGNER. That's correct, there is a captive finance company as we——

Senator WEICKER. And yet on the Datsun side, there is no such plan. Is that not correct?

Mr. WAGNER. That's correct, Senator. As I pointed out, there are only three captive finance companies: Ford, General Motors, and

Chrysler. The rest of the industry is not able to obtain financing except through banks, and at the suffering or at the pressure of the captive finance companies.

Now, their attitude has changed recently, GM, Ford, and Chrysler now will no longer finance import cars, so, consequently, when inventories do reach a higher level than they are today in the import field, there is going to be a tremendous scramble for money because there just won't be any available because the banking industry is no longer interested in the automobile industry, and the captive finance companies, as I say, only cover the major three, excluding even those dual dealers that have imports.

Senator WEICKER. Don't you think that would force Datsun——

Mr. WAGNER. I cannot finance my Datsuns through the Ford program.

Senator WEICKER. Wouldn't that force Datsun and Toyota to go ahead with their own programs?

Mr. WAGNER. They are attempting to do so. There is already an attempt by American Motors, which is, of course, Renault, an attempt to work through—I believe they are working through the Chrysler Corp. finance company to handle that situation. But, in the meantime, you are left out without any support in your import store, plus the fact that when you have a captive source of funds and no competition, they, in turn, dictate policies that do not make for very competitive situations.

I am not condemning them, I'm just saying that when you can only get your money from one source, naturally, they are not inclined to be the least expensive source or the most pliable source.

Senator WEICKER. My concern is that when people are not buying a home, when they are not buying automobiles, I don't really see where the economy is going. I think this has been the cornerstone of our economy, and the big ticket items are just not affordable in the sense of both price and the interest that has to be paid.

Mr. WAGNER. And the ripple effect, too, in this State, where we're supplying a large amount of the parts required in Detroit for their automobiles is going to be felt even more than it has in the last 2 years, because of the competition from overseas for producing those parts that were primarily produced in Connecticut. They are now being produced in Taiwan and Malaysia and places such as that. So that, in turn, is going to affect us even more.

Senator WEICKER. I'm delighted you came and testified, because as I said, the purpose of these hearings is to try and incorporate into the big picture the individual experiences back at the State level, and you've done that very well, and I thank you very much.

Mr. WAGNER. Senator, tomorrow Peter Griffin—I believe you know Peter from Greenwich——

Senator WEICKER. Right.

Mr. WAGNER (continuing). Will be testifying.

Senator WEICKER. In New York?

Mr. WAGNER. In New York.

Senator WEICKER. I think it's important that by the time they are through with all this high-flown rhetoric, that we understand the flesh-and-blood impact. That's what government is supposed to be about, not a bunch of theories, a bunch of philosophies, a bunch of political parties.

Mr. WAGNER. I think, Senator, your emphasis on the small businessman, your point regarding its being neglected, is very valid and something that most dealers, although we aren't considered small business, we are really small business. The industry is big business, but the dealership is owned by an individual. It cannot be owned by a corporation or franchise. It is a small business. We are the ones that are taking the brunt.

Thank you very much.

Senator WEICKER. Thank you very much.

Charles Atkinson of the Atkinson Construction Co. Is Dave Rakiec here?

A VOICE. No, he is not.

Senator WEICKER. Well, his dad was ill, so——

Charles, welcome. Nice to have you here.

Mr. ATKINSON. Thank you, Senator.

Senator WEICKER. We look forward to your testimony.

STATEMENT OF CHARLES ATKINSON, ATKINSON CONSTRUCTION CO., INC., NEW HAVEN, CONN.

Mr. ATKINSON. Senator Weicker, members of the committee, I appreciate the opportunity to testify before this committee and hope that my remarks will be helpful to its deliberations.

Time will not allow me to do more than skim the surface of the subject of high interest rates and its effect on small businesses.

The cause of high interest rates goes back to the 1960's, in which the American consumers, small businesses, and workers have been suffering the consequences of an inflation rate that has averaged over 6 percent per year. During the past several years, prices began to rise even more rapidly, at an annual rate exceding 14 percent, which cuts the real value of accumulated savings in half in a little more than 9 years.

Much of this acceleration of the inflation rates was accounted for by special factors. Food prices soared as a result of abnormally cold winter weather, and limited supplies of meat resulted from a prolonged decline in the size of cattle herds, major oil companies coming up with a fake shortage of oil, gas, and other related products in order to gain windfall profits, which only forced the inflation interest rates to new heights.

This major increase in petroleum costs, coupled with gasoline shortfalls, have severely strained the social and economic fabric of the country.

The recent worsening of the inflation problem, however, cannot be attributed solely to these factors. Other price and cost measures also indicated acceleration. Within the domestic nonfarm section, for example, prices are rising at double-digit rates.

Unit labor costs are increasing as wage rates have been moving up rapidly, while productivity growth has slowed. Wage increases are by no means the cause of our current inflation, but wage moderation is an essential part of the cure.

Average Federal pay nationally is almost $7,000 per year higher than average private industry salaries. In many sections of the country, they are out of line in that in addition to their regular salary increases—or biannual increases—cost-of-living increases are not based upon increases in productivity, but they are based on the fact that they are Federal employees; these increases annually occur. Private industry, particularly small business, cannot effectively compete with this sort of wage incentive.

The present inflationary interest rates are imposing severe havoc and hardships on many Americans; small businesses being the No. 1 target.

We cannot reinvest our savings, and so forth, back into our business to provide needed jobs, training, and so forth, to promote a more healthy economy that will tend to reduce government involvement and provide a more suitable base for the private sector to assist in turning things around on a more gradual basis.

Inflation and high interest rates also threaten the prospects for continued economic expansion. Inflation undermines consumer confidence, drives up interest rates, weakens the value of the dollar in exchange markets, reduces the future purchasing power of savers, and upsets business plans for investing in the new plants and equipment needed to foster healthy economic expansion.

Inflation and high interest rates have several causes. Reducing interest and inflation requires that we consider several initiatives. These include:

1. Federal monetary and fiscal policies must guard against the emergencies of excessive demands that, in the absence of comparably increased productivity, inevitably lead to accelerating inflation and higher interest rates.
2. Legislative action resulting in regulatory requirements designed to achieve social objectives and reporting requirements imposed to obtain data for the Government's statistical base must be carefully screened to minimize negative effects on cost and prices.
3. Ways must be found to break the inflationary psychology so that the private sector can assist in breaking the momentum of self-perpetuating price and wage increases that has become so deeply entrenched after years of inflation.

A balanced program must address all three of these initiatives. Relying solely on highly restrictive monetary and fiscal policies to reduce high interest and inflation could lead to recession.

Reliance solely upon voluntary measures taken in the private sector to break the momentum may not be effective if not supported by responsible fiscal and monetary policy.

No program will work unless the Federal Government promotes a proper balance between supply and demand in the economy. Government must also keep to a minimum those actions that directly increase private costs, create unnecessary costly regulations, costs and prices, increase payroll taxes, and encourage expensive favors to special interest groups.

Small business will be forced into a state of bankruptcy at an unpredictable rate, with minorities, women, socially disadvantaged, and economically disadvantaged suffering the greatest damages.

A civil and economic statewide war will break out in our inner city and State, therefore increasing crime such as breakins, theft and financial mismanagement, just to survive.

Technical education, basic 3 R's, education and health will take a back step of 100 years in order to accommodate a few people once they have put on paper.

Since racism and prejudice are a very large part of today's thinking, we have to assess the impact of minority, socially disadvantaged women and economically disadvantaged small business firms, and come up with some recommendations and actions that will neutralize the impact on the public and private sectors.

This is the most difficult of the problems of minority business enterprises, and until attitudes are changed, we will not see any growth in this area.

The present policy will greatly increase higher unemployment rates, lessen homeownership, there will be fewer business starts, and in general, havoc will have taken place with the riots in cities filled with bloodshed and sorrow, with people forgetting about God and having very little regard for their fellow man.

The outlook is gloomy and hard to predict, unless a change of policy takes place first within our own hearts, and then within the power to the people, such as the President of the United States, Congressmen and Senators, and public and private sectors.

It still is difficult for minorities to get a loan, even with the 90-percent guarantee, since SBA and Congress have seen fit to turn the lending priorities over to the private sector such as the bank participation loan programs.

The traditional private lender, bankers, are more reluctant to loan to minorities based upon future cash flow. It may not necessarily indicate discrimination, but my own experience tells me that the bankers see lending to minorities as more costly in terms of monitoring the loan, and they are not accustomed to dealing with minority firms.

Minority firms appear as risks to them, whether or not that should be the case. As a result, they prefer to make loans based upon collateral, and perhaps are more reluctant to make loans on future cash flow.

The new changed OMBE or MBDA has seen fit to place its contracts with the major accountant firms instead of minority business development agency. This is one program that the great white father has made that will backfire within a short time.

The present draft legislation Kemp-Garcia enterprise zone leaves many unanswered questions in regard to small business. It tends to favor Fortune 500 companies in its present form. In fact, everything coming out of Washington is in favor of large businesses.

We wish to thank you and your committee for giving me this rare opportunity to come before your committee. I am available for any questions that you have.

Senator WEICKER. Well, I thank you very much for your testimony, and I want to say something right now. Other people may consider some of your words there rather dramatic. I consider what you said to be true.

I think you are going to be very prophetic, unfortunately, in some of the things which are in that testimony.

I'd like to know, for example, what it is that, incorporated either in this economic game plan or in terms of legislation, is going to alleviate the unemployment problems that have been inherent in our larger cities and is still inherent. What do you know of, within the philosophy of this administration, that's on the books or that has been proposed that is going to change the present circumstances, which I think all of us will find unacceptable to our cities?

Mr. ATKINSON. To my knowledge, Senator, there is no current legislation that addresses itself to the desperate needs of the population of our inner cities.

I fail to see any concrete proposal for alleviating the joblessness through the present enterprise zone bill from major industry or the Fortune 500 companies.

I would greatly appreciate if you would show me anything to the contrary. All I see is people doubling up families.

I run a small firm, maybe 5 people or so, and I can see 50 people a week knocking on my doors in order to get a job. At present I work job by job, because I can't see a year ahead.

I see nothing but disaster, and I really can't see anything else the administration is doing that's going to increase the jobs as stated by the administration.

I mean there was some legislation on the books that was good. The housing programs are good basically. The present administration has seen fit to nip and tuck at all the affirmative action regulations.

Senator WEICKER. EDA is going down the tube, UDAG is going down the tubes, minority enterprise programs are going down the tubes, housing programs are going down the tubes.

I don't understand this, unless for some reason or other something has changed out there and we no longer have unemployed minorities and the cities are all cleaned up and everybody is happy and getting an education and has a roof over his head.

Mr. ATKINSON. That's not true.

Senator WEICKER. I know that's not true. I think parts of Hartford and New Haven that I am talking about are the same today as they were 5 years ago, 10 years ago, when people were worried about this. And you are damn right I'm worried about what's going to happen in the summers of 1982 and 1983 and 1984, because it's only so long it's going to stay quiet. It's going to explode.

Mr. ATKINSON. Well, people want to work.

Senator WEICKER. Damn right they want to work.

Mr. ATKINSON. For small business survival—you don't know, it's very dreary, it's on a day-by-day situation. There is no capital unless you can generate it yourself.

Senator WEICKER. I have, under the jurisdiction of the Small Business Committee, several minority-business development programs. I hear the biggest roar about the fact that funds allocated for minorities programs are misspent and nothing is going to happen, et cetera, and yet I sit there, and a disaster loan program administered by SBA—with apologies, Luther—but one farmer from Georgia, one farmer from Georgia, through duplicate loan applications and everything that went along with it, was ripping the Government off for a couple of million dollars. One farmer.

Mr. ATKINSON. I agree with you.

Senator WEICKER. Now, I think fair is fair, and let's understand where the waste, fraud, and abuse is. And I think it's high time we got rid of the notion in this country that the waste, fraud, and abuse lies principally in the area of programs to assist the minorities of this country.

Mr. ATKINSON. I can understand that since we are constantly criticizing the mere existence of the 8(a) program and its involvement in the DOD program as per 95–507, we constantly bring to the eyes of the public the many dollars that are surpassed to be wasted because of the extra cost of letting 8(a) negotiated type contract under said existing program.

We fail to mention the length of time that "The War Recovery Act of 1941" has been in existence by the mere fact that it still is used today.

It is one of the Department of Defense's major programs that is used by the large Fortune 500 companies along with its major defense contractor. In addition, they are given many tax breaks. Leasing is not necessary because of the continuing free use of Government equipment, building land, and so forth.

They have had some problems in the 8(a) program. I was involved in the 8(a) program several years ago, but that program is not necessary for me because the SBA has many problems they cannot solve. The blind cannot lead the blind. They have people who take care of a construction company one day, the next day takes care of a machine shop, the next day take a care of the drug store, and then banking. When he gets in over his head, he refuses to ask for call consultation service to obtain the needed expert who can provide sound business advise. We are aware that this is an in-house problem that has to be worked out within SBA and its Small Business Oversight Committee.

Senator WEICKER. You know, in the disaster loan program——

Mr. ATKINSON. They raise the interest up to prime, which is what happened to the disaster loan program, and when a situation takes place, there is no way that the person can make use of the lower interest rate and rebuild his home/business under the revised law.

Senator WEICKER. Anyway, let me say this to you, that I'm very moved by your testimony. I think it's right on the target, and I can assure you that you've been heard, and I hope a lot more people have the opportunity to hear you.

Mr. ATKINSON. If I have the time, though, I'd like to put in the record, that to my knowledge, the SBA in the 8(a) program, did not certify any new contractors last year nationally, we've met with some of the people in the SBA central staff, and when they do come to a meeting with the general public, they run the other way so as not to have to answer any questions.

I really don't know who they are serving, maybe Dave Stockman or the President or somebody else, not Small Business.

We hope that your Oversight Committee can take a look at this to see who they are serving.

Senator WEICKER. We will.

Mr. ATKINSON. Thank you very much.

Senator WEICKER. Thank you very much.

Our last witness is my old friend, Luther Stearns, the president of the Connecticut Farm Bureau.

Luther, good to have you here.

STATEMENT OF LUTHER STEARNS, PRESIDENT, CONNECTICUT FARM BUREAU, SCOTLAND, CONN.

Mr. STEARNS. Chairman Weicker, and members of the committee, my name is Luther Stearns. My wife, two sons, and I operate a 400-head dairy farm in Scotland, Conn. I am also president of the Connecticut Farm Bureau Association, an organization of 2,600 member families.

It is our belief that the deterioration of the U.S. economy is primarily the result of poor productivity. We feel that the recently enacted economic recovery program will encourage increased investment and productivity, discourage inflation, and promote a stable economy.

Inflation and high interest rates, while damaging to business, are not the causes of poor economic performance, but merely the symptoms of unwise tax and monetary policies enacted 1 to 2 years previously.

In 1980, realized net farm income was $24.3 billion, a decline of $2.7 billion from a year earlier. Interest expense was at $16.7 billion, up $4.4 billion from a year earlier. But all production expenses at $131 billion were up $12.4 billion. The real big kicker was that cash receipts from marketings were up only $6.1 billion from a year earlier.

Naturally, one could say that if interest costs had not gone up as fast, realized net income would have been higher. But one could also say that if other expenses had not increased as much, or had cash receipts increased more, then realized farm income would have been higher.

The same situation can be said for 1981. Current projections put realized net farm income at $22 to $23 billion, with receipts and expenses up, expenses up slightly more than receipts.

Lower interest costs would help, but that alone would not solve all the problems.

Farmers need a slowing in the rise of all input costs and higher cash receipts from marketings. High interest rates are a problem, for sure, but the problems in farm income go much deeper.

In short, improving productivity and controlling inflation, not just interest costs, is fundamental to longer term prosperity in agriculture and the country as a whole.

We need Federal tax and monetary policies that will encourage investment and discourage inflation and the psychology of spend now and pay later.

I would like to include, as part of the record, a communication from Robert Genetski, vice president and economist, Harris Trust & Savings Bank, Chicago.[1] He presents in greater detail the analysis and conclusions with which we generally agree.

I think I'd like to emphasize at this point—this is not a part of the printed testimony—that we feel strongly that we overreact as a public, as businessmen, and I might mention at this point that I am in sympathy with the automobile dealer.

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[1] Information not available at time of going to press.

In addition to our farm business, we established, approximately 2 years ago, a farm equipment business. We handle International Harvester and Kabota, so we have quite a similarity there in our perspective. And, certainly, high interest rates are hurting us.

I have a strong feeling, both as a farmer and as a small businessman, that high interest rates are a symptom of a much deeper problem, and that we need to develop some monetary and fiscal policies in the Federal Government that will promote investment and stability.

The inflation rate, I know many people feel, is a result of monetary policies established usually about 2 years previous to the high inflation rates, and we react as though this was something to be reversed in a month or two, or with an act of Congress or some immediate action by the Federal Reserve Board. I think often we create a yo-yo effect on the economy and on interest rates and inflation, that if we set our course and hold it a little longer, we can probably promote some stability which would promote investments and promote jobs.

I might say that I may speak a little longer than I should here, but I certainly agree that the problems addressed by the previous speaker—and I'm sorry that I didn't catch his name—and problems that are important to us all. We, in the Farm Bureau, feel strongly that we need to create a bigger pie, as badly as we need to devise mechanisms and methods to divide that pie equitably among every member of society, and that we have gone through a rather long period where we've been trying to provide a bigger slice of the pie for the underprivileged without increasing the size of the pie, and we've discouraged investment and discouraged the creation of jobs.

I might just mention that there is a huge market for small diesel tractors in this country, 30 horsepower and under, and not one damn one of them, Senator, is made in this country. About 90 percent of them are made in Japan. And in the last 2 years, that part of the farm tractor market has been the fastest growing segment of the market, and we are not competitive in producing that kind of industrial product here in this country. And I think it's a sad day, because it's not lower labor costs based on what we pay labor that created that situation, it's poor productivity, it's lack of investment. Those tractors in Japan are painted by robots, not cheap help. And we're way, way behind.

If we're going to address the problems that I think all of us in society want to address, we need to create a climate in this country where we can create jobs, not handouts.

You mentioned that disaster payment, and we are for eliminating that damn program.

Senator WEICKER. Luther, let me say I have no disagreement with any of your testimony. I think, first of all, where the disagreement arises is that if there is to be a rectification of past extensities, then the burden of that should fall on all shoulders. I think the feeling, as I perceive it—and I feel this way personally—is to say that everybody is going to have to hitch in their belt except the Defense Department can get totally unwarranted, huge increases. That's Government spending. Indeed, it's the most inflationary spending of all, because there's no consumer. But that's Government spending, and the people feel the same rules are not being applied to them. This is the waste, fraud and abuse with everybody else.

Second, I found very little quarrel in the business tax cuts, which is what you referred to in creating a bigger pie. And, indeed, it was my amendment to the tax package which cut the corporate tax rate in the lowest two categries. But I do believe that the individual tax cut was not warranted at this time. In other words, it far exceeded any of the spending cuts, therefore widening the deficit.

It's these inequities that are bothersome. In the final analysis, I think those have been pretty well established. The large corporations are going to come through this. There are going to be an awful lot of dead soldiers out in that field, and they are all going to be coming from the small business community. My good friends anywhere in the State of Connecticut who enjoy comfortable incomes will survive this disagreeable period. On the other hand, young people getting started, et cetera, are just finding it terribly punishing. And don't forget this, as you and I bought our first homes, I'm sure that we didn't have the cash in hand to buy it. Somebody was gambling on our ability to succeed in the future. Well, that chance isn't even accorded these people. And it's these concerns that bring us to these hearings.

But I agree with you. I have no problem at all with the fact that there has to be a straightening out of the economics involved, and I'll tell you one thing which I like, which is increasing the size of the pie. That's key, absolutely key, as you stated. It's just that the burden for all this should fall across far more shoulders than is the case right now in this economic game plan.

Mr. **Stearns.** I have a feeling it's falling on almost everyone, I'm sure unequally.

Senator **Weicker.** My good friend Don Conrad was here from the Aetna, and I'll tell you, Aetna does not have the same worries as my two homebuilder friends. I don't wish those problems on the Aetna, but I don't want to see these two fellows go out of business.

One of two things is going to happen. Either they are going to go out of business, or some big national homebuilding company is going to buy them up. And by the time we're through this attrition process, you are going to have a couple of big guys out there, and in the long run, I think that's devastating to the economy and the consumer as far as being inflationary, because competition holds down the prices.

Mr. **Stearns.** Farmers spent many years saying that Federal deficits create inflation. In fact, I think you and I had a discussion on that in your office. I guess to be more precise, Federal deficits in and of themselves are not necessarily inflationary, it's how we react as a society to those deficits, and whether we finance them by printing money or not.

Senator **Weicker.** I agree.

Luther, it is always good to have you here. You make good sense, and I must say that the Government would be better with you in it than out of it. Thank you very much.

The hearing will adjourn.

[Whereupon, the hearing adjourned at 11:50 a.m.]

INTEREST RATES AND BUSINESS CREDIT NEEDS

WEDNESDAY, OCTOBER 14, 1981

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
New York, N.Y.

The committee met, at 10 a.m., at Federal Hall, Wall Street, New York, N.Y., Hon. Lowell Weicker, Jr., chairman of the committee, presiding.

Present: Senators Weicker, D'Amato, and Nunn.

Also present: Robert J. Dotchin, staff director; James J. O'Connell, economist; Deborah L. Graham, press secretary; G. Thomas Cator, economist, minority; and Bruce Ray, Office of Senator D'Amato.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS

Senator WEICKER. The Senate Committee on Small Business hearings will come to order.

I would like to express my appreciation to our hosts in New York City today. Also, to my friends at the Whitney Museum for allowing us to use this facility, when, indeed, they have first claim on it, and especially to our esteemed colleague, Senator D'Amato, who is the home State Senator in this particular instance and whose idea it was that these hearings should come here to the financial center of the world.

Also, we have with us the ranking member, Senator Nunn of Georgia. Only by virtue of fate is he the ranking member, and I am the chairman. It could have very well been the other way around after the last election.

In any event, the purpose of these hearings is to take a look at the high interest rates: The causes, consequences, and outlook for the future.

There is no doubt that small businesses—homebuilders, auto dealers, farmers, to name but a few—are being devastated by high interest rates. Bankruptcies are running almost 50 percent above last year and new construction of single family homes is at the lowest point since the Government began keeping records. Literally thousands of small businesses, longstanding pillars of their communities, face extinction because of high interest rates.

It is not at all surprising that with interest rates going through the roof some people are starting to look for scapegoats. There is a suggestion that some sinister conspiracy in Wall Street or in the banks is keeping interest rates up so high. I say "nonsense."

The reason interest rates are so high is simple: A fast and loose Federal budget policy has collided with slow money supply growth, and this has bid up interest rates. The Federal Government is crowding out small business.

Let's face it: The arithmetic behind the administration's game plan just doesn't add up. The tax cuts cost $280 billion from 1982 through 1984 and the spending cuts save $130 billion. Meanwhile, defense spending was projected to grow by almost $120 billion from 1981 through 1984, with 1984, with the growth exceeding 1978's absolute level.

As I stated when the budget was being debated, you can't start with a 1981 deficit of $60 billion, and then cut taxes by $280 billion, increase defense spending by $100 billion and still balance the budget in fiscal year 1984—as I said, the numbers just don't add up. I wouldn't be a bit surprised if the fiscal year 1982 deficit went above $60 billion. And if we have a deep recession with persistent high interest rates, the 1982 deficit could go above $70 billion. Remember: Every 1-percent falloff in real growth adds $8 billion to the deficit and every additional 1-percent interest rate adds $2 billion to the deficit. Balancing the budget by fiscal year 1984 could easily require more than $100 billion of additional cuts in Federal spending.

Now some say Congress should just cut and cut and cut. But Congress has already cut the discretionary programs to the bone—there is very little room left for budget cuts.

Interest on the debt, defense and social security/medicare-medicaid alone account for over 60 percent of Federal outlays, and if you add in the other benefit payments to individuals—veterans benefits, unemployment compensation, disability, et cetera—you hit 80 percent. This means you have to cut $100 billion from 20 percent of the budget, so as the Congressional Budget Office says, you may as well close down the Government.

I don't think that's likely to happen and neither, in my judgment, does the U.S. financial community—and I don't blame them.

It seems to me that the unthinkable must now become thinkable: We should be willing to think about deeper cuts in defense spending—certainly more than the proposed token cut of $13 billion, or 2 percent of the total $667 billion 3-year defense budget; and I submit that we must give serious consideration to a delay in the effective date of the personal tax cut scheduled for July 1, 1982.

To be sure, interest rates have begun to drift downward somewhat. But for small business, that's like hanging a few inches closer to the floor of the scafford—you're just as dead.

I hope our witnesses today will educate us about this very vexing problem and advise us and the country as to what needs to be done and what the outlook is for interest rates and for our economy.

I appreciate your taking the time from your very busy schedules to be with us and know we will learn a lot from what you say. Senator Nunn?

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator NUNN. Thank you very much, Mr. Chairman. I am delighted to join you and our host, Senator D'Amato, here in New York.

I commend you for continuing our hearings on interest rates and their effect on the economy. I especially compliment you for holding today's hearing on Wall Street—the symbol if not the very heart of the Nation's financial community.

Responding to President Reagan's supply-side economic theories, Congress has enacted the largest tax cut in our Nation's history and significantly curbed the growth of the Federal Government by cutting spending. Many burdensome regulations are in the process of being reviewed or have already been abolished or reformed.

Many business and financial leaders predicted that these actions would inspire great confidence in the financial community here on Wall Street and in our small business community on Main Street. Our progress so far, however, seems to have raised about as many questions as it has answered—and Congress is left in a serious dilemma.

In fiscal policy, we have a huge disparity between tax cuts and spending reductions. Congress has enacted a total of $280 billion in tax cuts over the next 3 years, but it has matched those reductions with only $130 billion in spending cuts. That is a gap of $150 billion. The strict proponents of supply-side economics argue that the revenue-spending gap will be closed by increased business activity, more worker output, and increased revenue. Yet very serious questions remain as to whether that will happen.

Beyond fiscal year 1984, individual income taxes will be indexed to inflation. If inflation continues, in other words, Government revenue will remain static. Spending, on the other hand, will continue to rise because a large part of the budget, such as social security and other entitlement programs, are indexed to inflation. With revenues staying flat and spending going up, the revenue-spending gap can be expected to widen even further.

The prospect under this scenario is for continued Federal deficits and therefore continued borrowing for years to come. This outlook seems to have fueled inflationary expectations among private lenders. And, of course, this outlook is being reflected to some extent in the financial market every day. Despite some easing of the prime rate in recent days, these expectations and the tight money policy being followed by the Federal Reserve Board are resulting in high interest rates as measured by any standard.

Those high rates compound the problem by adversely affecting real growth in many vital segments of the economy, especially the small business and farming sectors. If they continue, it will be extremely difficult to achieve the 5.2-percent real growth rate upon which the President's economic program depends for success. Without that growth, revenues can be expected to fall short of the President's expectations, and the outlook for a balanced budget will be clouded even more.

The President has now given a partial answer to this question of the balance between fiscal and monetary policy. He proposes another $13 billion in spending cuts in fiscal 1982 and $80 billion in fiscal 1983 and 1984.

Yet even the Republican leaders in the House and Senate say that making further cuts of that magnitude in 1982 will be difficult if not impossible. The fiscal year has already begun, and that's what many people in Washington have not grasped. The fiscal year has already begun for most State and local governments. Many of them are already several months into their own fiscal years, and Congress is under pressure to hold the line on further cuts in the social programs upon which they rely for substantial parts of their budgets.

There are other political realities over the longer range. Deep cuts in most social safety net programs would be morally indefensible even if they were politically possible. And heavy reductions in the defense spending now after the President has already permitted 7 or 8 percent real growth would certainly require us to the very least, to reexamine some or our longstanding, at least in administration policies and foreign policy, particularly, our arms control policy, that now exist and so forth.

Cutting defense spending, certainly should not be excluded as a possibility. It is not a free ticket or a free item. But it has some very serious implications in both foreign policy and in our relationships with our allies and our adversaries.

Mr. Chairman, I will cut my statement short because we want to hear the witnesses.

There are many questions I have that I posed in my opening statement, but I would simply hold those for the witnesses and thank you again.

I will ask that the rest of my statement be put in the record.

Senator WEICKER. The statement will be put in the record.

[Material follows:]

There are other political realities over the longer range. Deep cuts in most social safety net programs would be morally indefensible even if they were politically possible. And heavy reductions in defense would renege on the President's commitment to long-term steady military growth and would force us to radically alter our foreign policy. We must pay the interest on the national debt.

If we exclude these budget items from heavy reductions, we are left with all other federal programs which amount to just $185 billion of the $720 billion budget for 1982. To make all the necessary cuts in these programs would mean severely limiting agricultural support payments, general revenue sharing, community development block grants, health and child nutrition programs, aid to transportation, cancer research, small business loans, education assistance, and many other valuable programs.

We must find our way out of this thicket, and I hope that our witnesses today can answer many of the questions that are before us and which I intend to ask today.

For example, what federal government actions would enhance the prospects for improvement in the financial markets and the interest rate picture?

Are we moving toward a dual economy in which firms with access to capital, high technology firms, and energy-related companies will flourish while businesses without access to capital at reasonable prices—especially most small businesses—flounder and eventually fail?

Are we headed toward a recession? If so, how deep will it be and how long will it last? Will only a broad-based recession reduce the pressure on interest rates?

How low must interest rates fall in order to spur investment, which is the key to supply-side economics?

Should the individual tax cuts be rolled back or delayed and how would that affect economic performance? If so, during what time frame should they be modified in order to reduce inflationary expectations?

These and other questions go to the heart of the difficult economic and political decisions Congress will have to make in the near future. They must be answered.

I look forward to hearing from our witnesses.

Senator WEICKER. Senator D'Amato?

STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Thank you, Mr. Chairman. I would like to commend you, the committee and Senator Nunn for taking the time to conduct these hearings today.

Small business forms the economic backbone of America. This has always been true and, hopefully, it will always be true. Small businesses have truly run into some difficult times as a result of the astronomical interest rates which they now face.

It is fitting that the Committee on Small Business investigate this problem because high interest rates adversely affect small firms to a much greater extent than they injure large companies. This is because of the higher debt-to-equity ratio and lower capitalization of small businesses. Small businesses must borrow if they are to finance the inventories necessary for them to stay in business. And, if they cannot afford to borrow, the fact of the matter is that they fail.

The number of failures and bankruptcies is now alarmingly high, especially in industry groups such as housing, farming and auto dealerships. Simply put, high interest rates are placing considerable restraint on the economy, perhaps more restraint than the economy—and the Nation's small businesses—can bear.

I am committed to working toward lower interest rates and to keep them down permanently once they have been lowered. Therefore, I am very anxious to hear what suggestions today's witnesses can make toward that end. Hopefully, we can return to Washington with a better understanding of how the Wall Street and banking communities view the interest rate problem and how we can effectively implement a program that makes sense for the economy of this Nation and for the small businessman, in particular.

Mr. Chairman.

Senator WEICKER. Thank you very much, Senator D'Amato.

The committee will now hear from its first witnesses.

The panel of small businessmen, Mr. John Porcelli, Porcelli & Associates, Stamford, Conn.; Mr. Peter Griffin, Griffin Ford, New Canaan, Conn.—is Mr. Griffin here—and Mr. Edward DeLuca, DeLuca's Pasta, Derby, Conn.

Mr. DeLuca, Mr. Porcelli, if you will come and be seated.

Gentlemen, proceed with whatever statements you care to make, and I am sure the committee will have questions. Please go ahead and do it in your own way.

STATEMENT OF JOHN PORCELLI, PORCELLI & ASSOCIATES, STAMFORD, CONN.

Mr. PORCELLI. Mr. Chairman, the home building industry in Fairfield County, as in the rest of the country, are in a state of wake. We are just waiting to be buried.

We cannot sell any of our inventory because the consumer cannot afford to pay these these high interest rates. It is something that is a matter of numbers, mathematics, and when the consumer cannot pay these high interest rates, they are certainly not going to buy our inventory.

By the same token, we builders are not building any houses and because of the fact that we are required to pay 2 points above prime for any construction funds that we receive as a result, as was pointed out by yourself, Mr. Chairman, the home building industry is producing the least number of houses since World War II.

I have been in home building since--for 30 years. The last two houses I built were exactly 2 years ago today. I still have them. I have not been able to sell them.

It is costing me a fortune just to carry them from day to day.

As you well know, interest runs Saturdays, Sundays, holidays, and every other day, and until that debt is paid, my interest bill is a major item in my construction costs.

The balance of 400 members in Fairfield County are marking time. A lot of them have left the business because of the fact that they have to make a living.

Cash flow is negative, and they have families to support and bills to pay, and as a result, all these factors put together, the home building industry is ready to be buried.

Thank you.

Senator **Weicker**. I know there will be questions.

Why don't we go to Edwad DeLuca and then the panel will ask questions at the same time.

Ed?

STATEMENT OF EDWARD DeLUCA, DeLUCA'S PASTA, DERBY, CONN.

Mr. **DeLuca**. Good morning. My name is Ed DeLuca, and I am an entrepreneur, and my address this morning will be toward the entrepreneur.

For the past 3 years, I have been the owner of a restaurant in Derby, Conn., called DeLuca's Pasta.

Next month I will be opening another restaurant. We are a family restaurant that serves good food. Prior to this venture, I was with Heublein which owns Kentucky Fried Chicken and other such things.

Despite the fact that I was doing very well there in terms of my income, job satisfaction and accomplishments, I decided to leave all that behind me and go into business for myself. I have always had that burning desire. I think there are a lot of people today who have that desire.

I was asked this morning by a group of young people, "What would you recommend to somebody who is first starting off in business today?"

I suspect years ago, the answer might have been, "You better get a good businessman, marketing man, and make sure you have a lot of backing for financial purposes."

Today, I would say to that person, "You must have aggressive optimism."

I had aggressive optimism 3 years ago in myself and in the business environment, and if I didn't have that optimism, I don't think I could make it because my energies are being sapped every day by the business environment I have no control over.

I took that risk, and I am glad I took it, and I hope there are a lot of other small business people out there that are going to take these risks because they are necessary for this economy if the entrepreneur is to succeed.

Today, the results are very gratifying. I opened up a restaurant where four previous restaurants failed in as many years.

Our sales are well in excess of a million dollars. We feed over 3,000 people a week. I employ 60 people in one of the most depressed unemployment areas in the State of Connecticut.

We received 21 unsolicited comments about our restaurant telling us how good it was. In fact, some of them are four stars, and the New York Times, which is very stingy with its stars, gave us two.

The reason I bring my background up is that I think it is important to know that I consider myself to be a successful businessman and a man with some knowledge, and even with all that, it is getting increasingly difficult for me to operate.

On the surface, it appears that I really don't have anything to complain about, and I felt so good 2 years ago at the completion of our first year being in business that we wrote this ad and put it in the newspaper, the local newspaper in New Haven and Naugatuck Valley.

> Isn't this what life is all about? A year ago last week, we opened our door to the public. I let the day slip by without fanfare (except a little party for the staff) because I wasn't sure the first anniversary at DeLuca's Pasta was important to anybody else but us.
>
> Then I had second thoughts. I think it is important.
>
> If you read the papers or watch the news, you could get the idea that there isn't much to celebrate any more, that life is all meanness and broken promises and bad news. Well, that isn't true about my life. It isn't true about life in the Valley or even this State. And if we don't lie to ourselves—it isn't true about life in this country (even in a slump, it's better than whatever is in second place.)
>
> I quit my job after thinking about it for years, and with my heart in my mouth, I opened a restaurant in a town where nobody knew me. What made me think I would be accepted? I guess the same spark of faith that made the DeLucas who came from Italy know that they would find acceptance here.
>
> It is a wonderful thing to be accepted, to belong, to be free to work and to succeed, to dream and make your dream come true, to know that there is food to eat and books to read, a roof over your head and clothes on your back. It is a wonderful thing to have a wife who loves you and to watch your children grow straight and strong and smarter every day. I have that. Most of us do here.
>
> I think that the first anniversary of DeLuca's Pasta is important just because there is nothing unusual about a nice little business like mine going on for a year or a dozen years. It happens all the time in this country.
>
> I'd like to say thank you. Thanks to all our wonderful customers and friends. Thanks to my wonderful staff, and thanks to all the people living and dead who helped to create and maintain the kind of social economy and financial fabric in which an ordinary guy like me can say things like this—and not only live the truth, but also see it published.

Where am I today? I look at my operating cost, and I see that my first year average of utilities was $1,500 a month. Now, they are at $4,500 a month and rising rapidly.

I look at my paper costs. They have doubled in 2 years. And on, and on goes the scenario of my profit and loss.

Last year, I felt very good about my business. We further developed our marketing plans and our long-range plans and felt that we had the business to expand. I brought my plans to Connecticut Bank & Trust. They reviewed them. They believed in us and they gave us a loan.

With that money, we built ourselves a commissary. We built a commissary on the basis that we were going to be able to open up two more restaurants which this commissary could service.

When we did this, we did this at rates we felt were reasonable rates, we felt we could pay. We were looking at 12 to 15 percent. We also felt that we had a timetable that would enable me to keep my cash flow deposited.

The only other thing we felt good about is that there were a lot of investors out there with money who would want to invest in our business. That was a business short-side.

Why? It is very simple. Today, those investors can go out on the open market and get 18 percent, and from at least 25 people I spoke to "without any risk."

I spent a lot of time trying to motivate these people to invest in my business, and I got them fired up and really interested in it, and they said, "Well, I am going to go see my accountant, my lawyer, my financial adviser."

And I said, "Absolutely. Please do so."

Frankly, I think that what is happening out there is that these professionals are telling people they are absolutely crazy to invest their money in a new business with great risk. Take it easy. Just go for that 18 percent.

Coming from a corporate environment and knowing many people in it, I feel very sad about the fact that these big businesses, presidents and other executives in the corporations, are looking at today's sales, are looking at today's profits, are concerned about their own businesses and are not investing money for the future, and this is coming down to the guy in the street who does not also want to invest in the future.

Big companies can go to the marketplace and get money at less than prime. They can issue stock. They can do whatever they want. I can't.

In fact, I am limited as to the number of people that I can have in my corporation. I am limited by the availability of money that banks will give me or other investors will give me.

In order for me to borrow money, my lawyers advised me to develop disclosure reports. I did that.

It cost me $18,000. That's a big part of my profit, so if I mainly get out and try to get the money, I have to spend a lot of money before I can even talk to someone, and I, for the life of me, cannot understand why the Government makes small businessmen like me, who are fighting these high interest rates, have to come up with a strong disclosure report before you can talk to anyone.

I believe you must notify the investor of the risk, but do you put further constraints when money is tight enough?

For the past 9 months, I spent a lot of time looking for this money. It has destroyed my time for opening up new businesses. The interest rates are going up, my costs are going up, and frankly, the last 2 months have really taken me away from my business, and my business suffered a bit as a result of it.

Fortunately, I did find a few people who would invest in my venture that I was opening up, but the well is now dry. I don't have anybody else I can go to that is interested in only getting 12 to 15 percent in a high-risk business.

I applaud the administration's desire to help small businesses and businesses in general, and all those new laws have been helpful. Certainly, it is nice to know I can be appreciated. It is nice to know that there are now a lot of new tax laws that are going to help me, but I ask you what good do they do me if I can't get the money to buy the equipment to depreciate, and that's my problem.

The Government, I think, has it in its power to help people like me, the small businessman.

For example, if the money invested in the business could be pretax dollars instead of after tax dollars, at least I might have a shot for some investors to put in money so that they can feel that they are not being taxed double, and almost without exception are being taxed doubly by investing in a business such as ours.

As to myself, where is the old American spirit that built this country and the entrepreneurial spirit, with people who are looking to take the risk, the big risk? I think that whole risk-taking is being destroyed today.

Am I pessimistic, no. I still have that agressive optimism because if I didn't, tomorrow morning I would be out of business. Are we a pessimistic breed? I really don't believe so. I believe there are a lot of guys out there like myself who are honest, who are hard-working and who will persevere in spite of it all, but frankly, the numbers are becoming few in terms of the starters, and the ones that do start are becoming failures.

I would not have been able to sit hear and speak to you about these problems 6 to 9 months ago because I did not experience them, but I must tell you they are absolutely real.

The reason I took a few moments out to read this article was to tell you that when it did appear, we got 50 phone calls that Friday that it appeared, and I got 15 letters, and the business was so brisk for the next 4 weeks, we had to put on extra people.

My guess is that if I ran this article today, I would get zero reaction. People have stopped talking to me about going into business for themselves because of the high interest rates, because of the failures.

They just have seemed to lose the optimism which I think was there not too many years ago.

Statistics clearly state that the small businessman is more responsible than anybody else for creating new jobs. I think it exceeds 60 percent.

There is a message I have to believe in. The message I believe in is that if we are going to create new jobs, then we must have new businesses, but to have new businesses, there must be capital for the entrepreneur.

Senator WEICKER. Thank you very much.

Gentlemen, two questions; one of you, John, and one of you, Ed.

John, at the present time, as you have indicated, the homebuilding industry is just about at a standstill, and from testimony that we received in Hartford, yesterday, and also down in Washington, several weeks ago, homebuilder after homebuilder is going to belly-up.

Now the most optimistic predictions that I have seen seem to say that at least for the next 3 years, we are going to be in a range of 15 to 20 percent on interest rates.

If that is so, if that is the most optimistic prediction, how do you look at yourself in your business and your colleague's business in that 3-year period?

Mr. **Porcelli**. I am going to start looking for a new job, Senator. I don't believe that I will be able to make a living with these high interest rates.

First of all, I might have the capability to build houses and finance them with my own funds or even if I wanted to go out and pay these high interest rates myself temporarily, but is the consumer going to be able to pay 15 percent, 16 percent interest?

Let's take, for instance, a normal house in the city of Stamford, Conn., is $200,000.

If a buyer was able to come up with $100,000 as a down payment, that means he would have to finance $100,000. At a 15 percent interest rate, the first year is $15,000 plus the fact that he is losing money on interest that he could have earned on the $100,000 that he put down as a down payment.

How much money does a man have to make to afford this ordinary $200,000 house in Stamford., Conn.? I don't see it. The numbers just don't add up.

It is easier of course, for a rich person to go buy a half-million-dollar house or a million-dollar house because they just write out a check for it, but the ordinary person——

Senator **Weicker**. That's what worries me. The statistics that come across are that only 3 percent of this country can now afford to buy a house, and as you go through our State of Connecticut, there are hundreds of unsold homes out there. That's their stake in America, and they are not buying.

The young people can't buy. They can't buy. I just wonder how long it is going to be that we can politically live with a situation where homeowning in the United States of America is the privilege of the few.

Mr. **Porcelli**. The fact of the matter is that homes, of course, are the second most important thing to a person's existence outside of food, which is first.

We have always competed for money with Wall Street, with big corporations and so forth, and it seems to me that there is—there should be some sort of a vehicle where the home buyer is not subject to the fluctuations of the money market of Wall Street or of the prime rate. They should be completely separate.

I don't know how this can be accomplished. I am not a financier, but it seems that if Uncle Sam is going out in the open market and paying 12 or 13 percent for the money that we owe, other people are ready to pay even a higher interest rate, so if the home buyer is going to compete with all the big business, well then, there is no such thing as a small business any more. It is the end of it.

Senator **Weicker**. Ed, my question to you is that you started out one man, leaving a major corporation and started a business in Derby, Conn.

That business today employs how many?

Mr. **DeLuca**. Sixty people.

Senator **Weicker**. And, as you indicated, in one of the most depressed areas in the State.

Mr. **DeLuca**. Right.

Senator **Weicker**. You then committed to the opening of a new restaurant, which is going to open up sometime in the next several months.

How many will that employ?

Mr. DELUCA. At least 60.

Senator WEICKER. It is my understanding that you had in mind a third restaurant.

Mr. DELUCA. That is correct.

Senator WEICKER. Under the present economic circumstances, have you slowed down the planning for that third one?

Mr. DELUCA. Yes. The reason for that is again the incapability to attract the capital to invest, and people are getting very nervous out there, people with a lot of money, and they are just unwilling to take that big risk, and they say to me, "Well, I can just sit back and do nothing and make 18 percent on the money market. My financial adviser told me to do that."

Senator WEICKER. Had you known of the economic conditions that exist, do you think you would have had second thoughts about opening the second restaurant?

Mr. DELUCA. No. No, because I believe we are going to survive, and I think there are opportunities out there, and I think it is going to be a heck of a lot better.

I can't overemphasize the need for aggressive optimism.

Senator WEICKER. I think you will agree a small business supplier is almost about 90 percent of the new employment of this country.

There is one man, 60 persons hired in Derby, 60 more.

There is the multiplying affect.

Senator Nunn.

Senator NUNN. Thank you, Mr. Chairman.

I want to thank both of our witnesses for appearing today. You are telling stories very similar to what I have heard all over my State.

Just a couple of questions for each of you.

Mr. Porcelli, what would it take in terms of interest rates declining for the homebuilding industry to be able to start on at least a gradual comeback? What level would the long-term rate have to go?

Mr. PORCELLI. Well, you put a tough one in front of me, Senator.

Well, the first mortgage rates up in Connecticut right now are up around 18 percent with a couple of points up front. Anything lower than that, it seems like it is good news.

A lot of people are talking about maybe they will go along with 13, 14, even 15 percent, but I guess the biggest push would be an indication that rates are coming down and not slowly, but fast.

How that can be accomplished, I can't answer that.

Senator NUNN. As far as you are concerned, if you had a choice of having a long-term interest rate come down to the 12- to 15-percent range, as opposed to where it is today, in exchange for having a rollback or stretchout, a significant stretchout of the tax cut being enacted, which would you choose?

Mr. PORCELLI. I would give up the tax cut, quite frankly, because I believe that with the economy turning around and more people working and so forth, Uncle Sam is going to collect more in taxes, and there wouldn't be any deficit.

I think our biggest problem in the past 20 years is that the Federal Government has been spending more money than they have been taking in, and it is where our biggest problem is. I know I couldn't survive year after year with a deficit spending. I would be bankrupt.

How Uncle Sam does it is a phenomenon to me.

Senator NUNN. Is the tax cut going to mean much to the homebuilding industry?

Mr. PORCELLI. Well, it is so small, quite frankly, it is not a tremendous tax cut. It might at the end of 3 years, I believe, President Reagan projected a 25-percent tax cut in the next 3 years.

Senator NUNN. Right.

Mr. PORCELLI. I would rather see less deficit spending, and a big budget and a tax cut would come ultimately then.

Senator NUNN. Mr. DeLuca, could I ask you the same question? If you had your choice of having interest rates, and I am speaking now long-term rates, dropped 4, 5 percentage points in exchange for a rollback, stretching out, or significant modification of the individual tax cut, which would you choose?

Mr. DELUCA. I would take the same position. I would prefer to see the interest rate come down.

This would better enable me to borrow money and to expand, and therefore create new jobs and hopefully create new tax revenues for the Government.

And second, I am at the mercy of the farmers, I am at the mercy of the trucking companies. I am at the mercy of everybody, and if in fact, they can get their businesses under control, then I might be able to plan my business better and do a lot better job and not have to increase my prices just to stay alive.

Senator NUNN. So, you would both rather see the tax cut modified than to see the tax cut stay in effect, if that means that interest rates are going to continue in their present range?

Mr. DELUCA. That is correct.

Mr. PORCELLI. Right.

Senator WEICKER. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

First, let me commend both of you gentlemen for coming in and putting in capsule form what is taking place in the small business community.

As you have indicated, Mr. Porcelli, the homebuilding industry, with exception of rare cases where the extremely wealthy are concerned, is all but dead.

In Long Island, as in all of New York, that is the case. Frankly, in middle America young people find themselves totally unable to purchase homes even if they husband the necessary resources for a downpayment. The monthly carrying charge goes far beyond their ability. This portends great difficulties in the future.

Before I ask a question, let me say that Mr. DeLuca told a great story of the pride of the small businessman, his own great pride and the ability of this Nation to afford him the opportunity to partake of its plenty.

Had you been forced to face the kind of interest rates that exist today, would you have been able to or would you have made that initial move to go into business? Would you have been able to undertake it?

Mr. DELUCA. Knowing myself, I know I would have at least attempted to get into business. My guess is that I would not have been able to attract the money necessary to build it.

I have every dime I own invested into these companies, and I have no other source, and I don't think that I would have been successful on a brandnew venture such as maybe to attract that money even with my background.

Senator D'AMATO. So that the essence of this is, with your schooling, with your ability as a manager displayed as a successful manager of a large corporation, attempting to go out on your own, you would have not been able to undertake this task; hence, 60 jobs, the employment you have afforded, would have been lost to the economy.

Mr. DELUCA. I would say so.

Senator D'AMATO. Do you say that that is the condition today that exists not only for you but for others that would like to go out and form their own business and bring out venture capital?

Mr. DELUCA. As I said earlier, a great number of people used to come into my restaurant and talk to me about starting a new business. I haven't heard any conversation like that in over 4 months.

Senator D'AMATO. Mr. Porcelli, what we can conclude on the basis of your testimony and through your experience in the industry of homebuilding is that it is all but dead with the exception of those few examples of construction for very wealthy people.

Mr. PORCELLI. It is, just about.

I would like to make a comment.

We received notification, and it was substantiated by the U.S. Census Bureau, that in the 1980's there is going to be 40 million people turning the age of 30, which is the prime house buying time, and the 1980's looked like they were going to be very, very good for us.

Well, we have gone through 1980, we are almost through 1981. We have gone through almost 20 percent of the decade, and I haven't made a nickel yet in this decade. Believe me, I haven't.

So what is going to happen? This pent-up demand that is—it is building up every day. I am afraid that once these rates do come down, the buying surge is going to be so great that the demand is going to outstrip the supply, and you know what happens when supply does not meet up with demand. Prices go back up again.

Senator D'AMATO. I find both of your responses to Senator Nunn's question very interesting in terms of the possible deferral of the implementation of the tax cuts. Asked if you would be willing to trade in, so to speak, a deferral of that reduction for assurance that this would result in lower interest rates, both of you have answered that you would.

Do you think that in the business community, particularly the small business community, that this is the general feeling?

Mr. PORCELLI. I would like to tell a story.

Years ago, my brother-in-law was my partner, and I hated to pay taxes, believe it or not, and my brother-in-law used to say to me, he says, "John, let's pay. Make the money and then we don't have to worry about paying the taxes. I hate to pay taxes, too, but that means we are making money." So the heck with the tax cut. Get us back in business, get us working, get people working again, and we are all going to be better off, but you have to get those rates down.

Senator D'AMATO. Thank you very much.

Mr. PORCELLI. You're welcome.

Senator WEICKER. One last question, since we are sitting here on Wall Street, and I know we have other panels that we want to hear from, but every time I pick up my newspaper I see where some large corporation is buying up some other corporation, and this has been going on for the past year, and my question to you, John, is: In the homebuilding area is it true that you are having large homebuilding corporations that are able to move in, if you will, and take over from the little guy?

Mr. PORCELLI. There will always be small homebuilders because the large homebuilding corporations have to work on large tracts of land for their operations to be efficient.

A small builder like myself will maybe develop 10, 20, 30 acres, or there are builders that just go from lot to lot. They will build one house, and when they sell that, they go on to the next.

The thing that upsets me with these large corporations buying other large corporations and borrowing the billions of dollars to buy these other corporations, they are drying up the money supply.

Maybe I am wrong, but if they have got to go to a consortium of banks to borrow $500 million to buy another corporation, aren't they drying up the money that I could use for my business? And they are big enough. I am still trying to make my first money.

Senator WEICKER. It is an allied area in the real estate area.

You have all these small real estate agents, and then because they can't deliver in the sense of finance, for their customers, they gradually get to the point where they either go out of business or a company like Caldwell Banker comes along, buys them up, and Caldwell Banker buys up all these small real estate agents and become one of these big real estate firms, and then lo and behold, who comes along and buys up Caldwell Banker? Sears, Roebuck.

Mr. PORCELLI. And they also bought Dean Witter.

Senator WEICKER. What I am saying is, what keeps prices down in this country is competition.

Mr. PORCELLI. Absolutely.

Senator WEICKER. And in this whole area of real estate and building, et cetera, I see a consolidation taking place.

As a matter of fact, one of your homebuilders yesterday in Hartford indicated that he used to be able to go to dozens of suppliers of his goods to build his homes, and there was a lot of competition.

Nowadays, he is restricted to about three or four, and there is only pennies' worth of difference between them.

That is what I have my eye on as the chairman of this committee. I am not a chairman of a judiciary committee or of antitrust.

I am here to protect small business because as long as small business thrives, there will be that competition. There will be the best product at the lowest price, and the minute we have big real estate agencies in this country, big homebuilders, believe me, the consumer is going to pay through the nose on that proposition, and that is what this high interest rate, the shortage of capital and high interest rates, is creating right now for the small businessman.

Mr. PORCELLI. I have often wondered some time ago, and I don't know how far back it was, the Government established the Small Business Administration, and we builders have always been excluded from participating in any Government-assisted loans for our businesses.

I often wondered about that.

Senator WEICKER. Well, let me put it this way: the whole administration, the whole concept of the Small Business Administration, is being revamped, turned around, and I think that is one thing this committee has tried to accomplish just over the past year.

Gentlemen, I thank you very much for taking time to come down here and give us the small business point of view. I appreciate it.

Mr. PORCELLI. Thank you.

Senator NUNN. Thank you very much.

Senator D'AMATO. Thank you.

Senator WEICKER. The next witness is Mr. Jay C. Harbeck, senior vice president of the U.S. Trust Co., New York.

Mr. Harbeck.

Why don't we also ask Dr. David Jones, chief economist, Aubrey Lanston & Co., New York, to come to the table at this time and Dr. Edward Yardeni, chief economist, E. F. Hutton, New York, so that we can have all three of you make your presentations, and the last panel will consist of Mr. Pedersen, and Mr. Maude.

Mr. Harbeck, Dr. Jones, Dr. Yardeni, it is very nice to have you appear before the committee. I greatly appreciate your giving of your time.

Mr. Harbeck, why don't you proceed.

STATEMENT OF JAY C. HARBECK, SENIOR VICE PRESIDENT, U.S. TRUST CO., NEW YORK, N.Y.

Mr. HARBECK. Thank you.

My name is Jay Harbeck, and I am a senior vice president of the U.S. Trust Co. of New York, where I am in charge of the fixed-income department for public and private pension and various other institutional fixed-income accounts.

I have a bachelor of arts degree from Princeton University and an MBA from the Harvard Business School. I have worked in the securities industry for 19 years, as a salesman for NYSE member firms, as the head of the investment department of a major life insurance company, and now in my present position at the U.S. Trust Co.

I am pleased to have the opportunity to speak to you briefly this morning on the subject of high interest rates, a problem that has persistently troubled both you and me for a number of years.

I recognize that some of your colleagues in the Senate labor under the assumption that high interest rates mean large profits for the banking community. This populist notion is both inaccurate and dangerous. I say dangerous because high interest rates are a symptom of economic dysfunction that must be addressed if our capitalist system is to work in a healthy and dynamic manner. Interest rates are like a thermometer in the mouth of a sick man. They register the degree of seriousness of the problem, but they neither cause the illness nor cure it.

Interest rates are a free market consensus expression of confidence, if any, in the future and, believe me, no one is more anxious to see interest rates drop than those of us who are professional investors in the bond market.

Now, in the course of these sessions, I know that you will hear from many economists who will describe in great detail, possibly excruciating detail, the causes of high interest rates and the burden they place on the flow of funds in our country. I am not an economist, I am an investor. I have the responsibility for the management of almost $2 billion in fixed-income securities. Over the past 10 years, the U.S. Trust Co. has ranked No. 1 in performance in terms of total rates of return as measured against other banks in the country. You might think that I would be pleased with high interest rates because they produce a high return. I am not pleased. I am not pleased at all because high interest rates mean low bond prices. When I speak in terms of "total rate of return," I am talking about two different factors: The coupon return I get from my bonds as cash flow and also the market value of those bonds, measured as a percent of their maturity value. I will give you an example of this in a moment.

Although I am not an economist, I listen to economists all day long. It is part of my job in trying to project where interest rates are going. In the course of working with the highly respected economists at the U.S. Trust Co., Dr. James O'Leary and Dr. Thomas Synnott, we have projected a scenario which is hardly soothing. We are forecasting an extended period of historically high interest rates.

We believe that the Reagan administration's current program of circumscribed spending cuts and increased defense appropriations, coupled with tax reduction, will lead to even higher rates than presently exist. We believe that any movement toward lower interest rates will be temporary.

Until there are some fundamental, and I stress fundamental changes in the Government's economic program, we do not believe that the battle against inflation and the high interest rates caused by inflation can be won.

We believe that yields on long-term bonds will remain high for some time to come and may possibly go even higher.

What we need to do, I think, is put this somber prediction into perspective, an economic perspective, because there is some misunderstanding about the causes of high interest rates.

The popular misconception is that high rates are established by the banking industry to generate profits and that they thwart the Government's attempt to lower the rate of inflation. A typical editorial cartoon will show an overweight banker in a frock coat with "Wall Street" emblazoned across his ample belly. And he will be choking a ragged little fellow, "John Q. Public," with a cord labeled "Interest Rates." Nothing could be farther from the truth. Bankers are not responsible for the level of interest rates. Government economy policy is. The bond market is influenced by what investors perceive to be the future results of that Government policy. Interest rates reflect supply-demand conditions in the money and capital markets, particularly the Federal Government's demands. If interest rates are high, it is because the majority of investors believe that the future rate of inflation will remain high.

Let me share some data with you that illustrate the present situation. Over the past 30 years, the Federal deficit has ballooned to truly unimaginable proportions. I have furnished you a chart which shows what has happened to the Federal deficit since 1950. You will note a catastrophic climb to the $60 to $70 billion level over the past 5 years. Now, deficits, in themselves, are not the problem. Philosophically, I am not opposed to deficit spending as a legitimate Government policy. It has proven a useful tool in stabilizing erratic economic conditions in the past. But when that deficit is monetized, that is, when it is financed through the bond markets, then the problem develops.

I call your attention to exhibit 2. Coincident with the chart on the Federal deficit, I have furnished a chart on the yields of Government securities for the same period. You will note a remarkable similarity in the slope of the curve. The greater the amount of the budget deficit, there is a coinciding higher plateau of interest rates. This is because the Government finances its deficits through the issuance of bonds. These bonds, being full faith and credit of the United States, the premier borrower in the debt marketplace, crowd out the bonds of all the other borrowers, namely corporations, who are also trying to finance their activity in the securities markets. But they must step aside, get crowded out, so to speak, when the Federal Government comes in with its first call on the available investable funds.

My third chart shows you how dramatic this crowding-out effect has been for the past decade. From an almost negligible position in the long-term market in 1972, U.S. Government bonds have mushroomed almost to a parity with corporate bonds in 1981. The Federal Government's enormous demands for funds have simply engulfed the credit markets like a tidal wave.

What happens when this occurs? Well, the old law of supply and demand starts to operate. When the supply is greater than the demand, prices go down. When demand is greater than supply, prices go up. In the case of the bond market, the demand for funds is swollen well beyond the supply of money available for investment. So the price goes down, and the reciprocal of price, which is the interest rate, goes up.

To give you an idea of what happened last year, in 1980, let me direct your attention to exhibit 4. This is entitled "Gross Additions to the Corporate Bond Market in 1980." Here I have included all Government borrowing, short term as well as long term. The total comes to $113.6 billion. You will note that corporate borrowing, through public bond offerings or private placements, totaled less than half that figure.

Now, many of us have interpreted the results of last year's national election as a mandate to effect some change in this dismal state of affairs. It is ironic that the Reagan administration has focused on our central economic problems more practically and realistically than any previous administration in the past 30 years, only to be confronted with the highest interest rates of the century. The recently signed tax-reform bills are a major effort to redirect the financial resources of the country. Yet the specter of continuing high rates of inflation remains. Many Federal programs were mandated in the more sanguine atmosphere of days gone by. The momentum of the growth of their expenditures continues unabated. The administration's ambition of a balanced Federal budget by 1984 is, to all practical extent, not achievable.

Now, the question that has been plaguing both the executive branch and you gentlemen in the legislative, as well as myself, is this: Why haven't interest rates started to come down since the inauguration of Ronald Reagan some 9 months ago?

Well, to some extent, I think it is a question of patience, or rather, impatience, on the part of the administration. Bond buyers in the past have been burned, more often than not, by listening to the optimistic voices in the Government. Back in the 1960's, Lyndon Johnson tried to "jawbone" interest rates down. More recently, numerous administration spokesmen have been predicting that a significant decline in the rate of inflation will occur forthwith.

We bond buyers have heard this song before. Let me give you an example: Early in my career as a bond salesman—on August 31, 1966, to be exact—an historic bond issue was marketed. Standard Oil Co. of Indiana offered $175 million 6 percent sinking fund debentures due September 15, 1991. The issue was rated AAA by both services. It was an extraordinary large amount of bonds at that time from a bluechip issuer at a record 6 percent yield. This was back in the heady days of guns and butter, when the Government told us bond managers that everything was possible. That Indiana 6 was a blockbuster offering. We had never seen anything like it before and never expected to again.

Well, gentlemen, now that Indiana 6/1991 is trading at a dollar price of $57.75, almost half the price where it was offered 15 years ago. There are not many other investments you could have made in 1966 that would have lost half their value in current dollars. In terms of the buying power of the dollar, due to inflation, the 1966 dollar is worth only 37 cents today, so the constant value of the Indiana 6, bought for $1,000 in 1966, is now about $213.

Looking back 20 years, the idea of a then current rate of inflation of 5 percent was unthinkable. Through the entire decade of the 1950's, the average annual rate of inflation was only 2.1 percent.

So, in 1970, when inflation was at a 6-percent level, we were told that it couldn't last, that this was the United States, not some banana republic. But it did last. What's more, the higher the rate of inflation soared, the more it became institutionalized, the more we learned to live with it, to invest in hedges against it. People bought houses and common stock and all kinds of tangible assets that would beat inflation. Pension and welfare benefits were indexed to float up with inflation. The rising tide lifted all boats, or nearly all boats unless you were unlucky enough to have bought fixed-income securities. But bondholders have never had enough political clout to matter.

There is something very fundamental in what the level of interest rates is telling us right now. The current high rates tell us about a psychological momentum built into the American system. For the past 20 years, business expansion and consumer spending have been fueled by the credit markets. Skyrocketing prices, aggravated by ever-higher labor costs and never-ending increases in the price of energy, have been blithely absorbed along with the skyrocketing cost of money. What happened in the past was that eventually high interest rates triggered a business slowdown and a cooling off of demand for goods and services. In the face of reduced demand, the economy would recede and interest rates would come down. But now the economy seems to be receding at last, and yet interest rates remain stubbornly high. Observers scratch their heads and wonder why?

We suspect that the credit markets are looking beyond the projected recession, beyond even the remaining years that the Reagan administration will be in power. We suspect that other bond managers, like ourselves, are asking these questions: How long will the budget cuts now being put into motion stay in effect? Through 1982? 1983? 1984? Most Federal programs, alas, do not look much beyond the next election. What seems like political courage one year may melt into political expediency shortly before the voters assemble at the polls. In short, what are the chances that a belt-tightening, budget-trimming, fiscally conservative program will have staying power?

And this is the crucial issue. In terms of fundamentals, President Reagan has identified and come to grips with the nagging problems of the Federal deficit. But now, in the first sortie in the war, the easy spending cuts have been made. We bond managers now ask you legislators in Washington this question: "Where do you go from here?" Already there are disconcerting signs that Congress is sensitive about additional budget cuts. Every cut, from now on, is going to hurt somebody in your State very badly. That somebody is a voter. What will your reaction be when he screams with pain?

The difficulty is that in order to bring inflation down, in order to trim that swollen deficit, a lot of components that make up inflation will have to come down as well. Wages, for example, will have to be held in check. The prices of houses and all the other tangible assets that people bought as a hedge against inflation will have to stop escalating if we are going to return to substantially lower levels of inflation. All those boats that rose with the tide are going to have to drop as the tide goes out. The social welfare programs, the personal entitlement programs, all of the indexed safeguards against higher levels of inflation will feel the effects of lower levels as well. Disinflation can be painful and politically unpopular. Our friends in England can testify to that.

A national psychology shaped by a generation of inflation may not enthusiastically endorse a long range program requiring patience and restraint. I am sure that every elected official keeps the example of Winston Churchill in the back of his mind. Churchill promised the English people nothing but "blood, sweat and tears," and although he held them together during the darkest hours of the war and was one of the most popular political figures of all time, the first chance they got to vote, they voted him out of office. So much for blood, sweat and tears.

Patience and restraint: That's what we need, but governments are not particularly noted for patience or restraint. Elected officials like to see immediate results of their programs, or, at least some visible progress when election day rolls around. But what we are talking about here, the revolutionary limits being put on public spending for the first time in a generation, may not show any results right away, at least not in the bond markets, where we have been bloodied for years. It will take time and patience to convince bond buyers that this time around things will really be different, that Congress will not retreat in the face of the difficulties involved in holding the line.

I remember the WIN buttons of two administrations ago—Whip Inflation Now, but we didn't whip inflation then, we capitulated to expediency instead of following through.

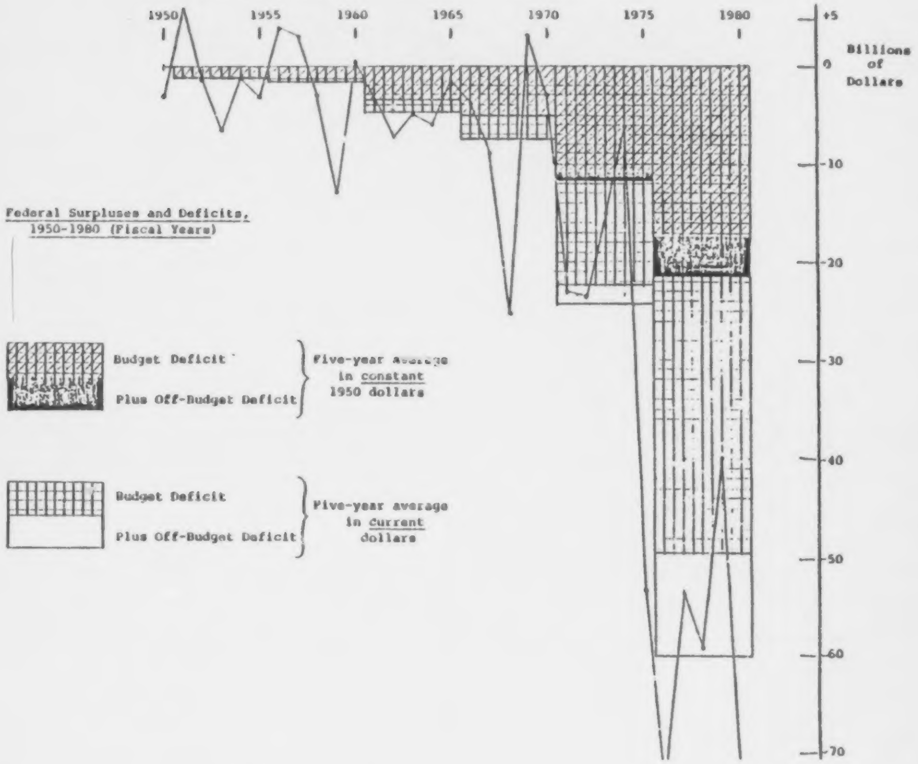
I have tried to show that inflation has been a longtime problem, high interest rates did not spring up overnight, they will not go away overnight. It is up to Congress to maintain a consistent course in controlling and reducing inflation. If Congress is consistent, interest rates will retreat, slowly, to be sure, but steadily. Don't blame high interest rates on greedy banks. Everyone suffers when the cost of money escalates beyond reasonable limits. If interest rates are anything, they are a barometer of the confidence of the American people in their Government. We haven't had much reason to be confident about the future in recent years. it's time we got started again. Thank you.

Senator WEICKER. Thank you very much. and we will get to questions later.

[The attachments to Mr. Harbeck's statement follow:]

EXHIBIT I

FEDERAL DEFICITS: A WORSENING ADDICTION



Source: Lehman Brothers Kuhn Loeb.

EXHIBIT II

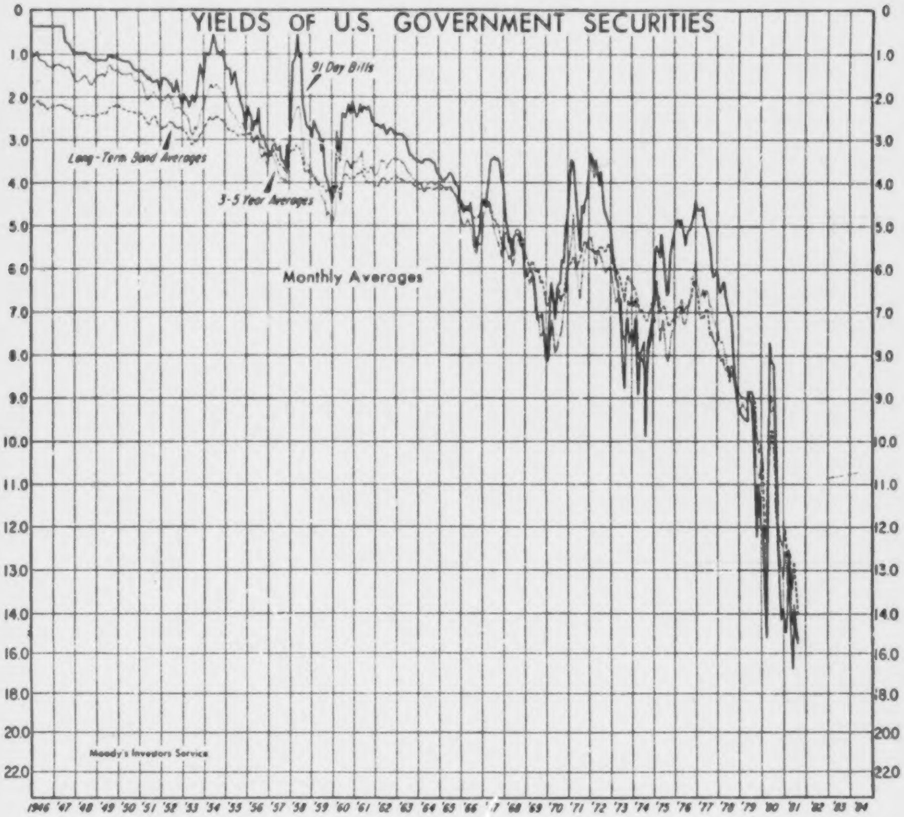


EXHIBIT III

Chart 4. Gross Issuance of Long-Term Bonds — U.S. Govt. & Straight Corp., 1972-81 ($ Bils)

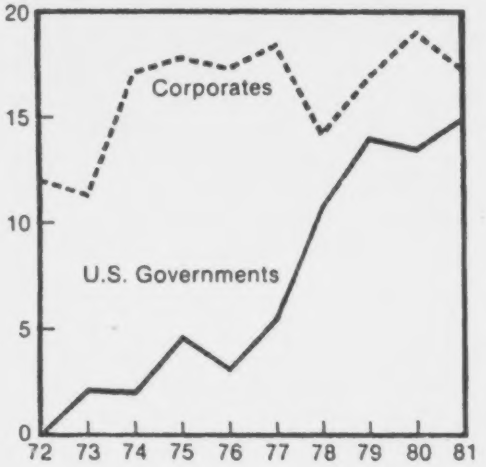


EXHIBIT IV

Gross additions to the corporate bond market in 1980

	Billions
Corporate bonds:	
Long-term, public	$36.6
Long-term, private appx	15.8
Municipal bonds (long-term)	46.3
Government notes and bonds	113.6
Pass-through securities:	
GNMA	20.6
FHLMC	2.4
Privately issued	.2
Preferred stock	1.9

Senator WEICKER. Dr. David Jones, chief economist of Aubrey Lanston & Co., will speak next.

Dr. Jones.

STATEMENT OF DR. DAVID JONES, CHIEF ECONOMIST, AUBREY LANSTON & CO., NEW YORK, N.Y.

Dr. JONES. Thank you very much, Mr. Chairman.

In the interest of time, I will read my introduction, summarize the main concept of my remarks, and read my recommendations, if it is all right with you.

Senator WEICKER. Fine.

Dr. JONES. My name is David Jones. I am a vice president and economist for a primary dealer in Government securities.

The U.S. economy is in a period of deepening crisis and vulnerability. This crisis—which is far more profound than many realize—will test us all in the months ahead.

The seeds of this crisis have been sown in a viciously accelerating process of inflation and inflation psychology in the past decade or so.

Although this inflationary binge owes much to outside forces such as the world food crises of 1972 and 1980 and the oil price shocks of 1973 and 1979, the real "engines of inflation" have been excessively accomodative monetary and fiscal policies.

It is now time to pay the piper. However, the transition to a less inflationary economy requires a change in the mentality of inflation on the part of consumer and businessmen alike.

The issue is whether this transition will be harsh and damaging, involving a prolonged period of high interest rates, widespread bankruptcies, and a deep economic recession, or whether it will be a shorter-term process involving a soft landing in economic activity.

The first ingredient of the shift toward a less inflationary economy has been the application of monetary discipline. The Federal Reserve, in an increasingly successful effort to establish anti-inflation credibility, has set out to deliberately starve the economy for new money and credit in 1981 and 1982. However, this tight money stance is currently clashing violently with the loose fiscal policies of the Reagan administration—including the 3-year tax cut and sharply increasing defense spending. It's this dangerous and unstable economic policy mix—to be feared just as much as an unstable or volatile scientific mixture of chemicals—which has been behind the August–September shock wave through the bond and equity markets. The simple fact is that monetary dicipline has to be accompanied by fiscal discipline if the transition to a less inflationary economy is to be relatively smooth and lasting.

The August-September fears of the thousands of buyers and sellers putting their money on the line in the bond and stock markets centered on the prospect that the clash between prolonged tight money and loose fiscal policies could keep interest rates at or near record levels for yet another year or more.

The harsh reality—particularly for small businesses (and even many larger ones), for mortgage borrowers, and even for State and local governments—is that they may be shutout of the financial markets completely or that they may get no more than the tag ends of the increasingly scarce new money and credit supplies, once the greedy Federal Government inevitably elbows its way to the head of the line of prospective borrowers. With such "crowding out", there would be widespread financial failures and bankruptcies—already running in 1980 at twice the rate of 1979. And I would just like to update those figures with some failures.

I was just able to learn that for the last week in October, the latest number we have there were 468 business failures versus the same week last year, 204.

So we are running at double the failure rate even in the most recent economic statistics.

Unfortunately, in this situation of increasing friction between the Federal Government and other borrowers, the only longer-term relief from financial strains would come with a sharp resulting drop in real economic activity, accompanied by rising unemployment. In this case, business borrowers would—after a temporary period of frantic borrowing in anticipation of a feared crunch, or to enhance strained liquidity positions, or to cover involuntary inventory build-ups—pull back, leaving the Federal Government to borrow largely in a vacuum.

I will summarize the general text of my remarks to say simply this: In my view, the Federal Reserve has established anti-inflation credibility.

That is no longer the issue, and by the way, I would commend the "Humphrey-Hawkins" act of Congress as a method which the Fed has used effectively to establish annual money growth targets which will squeeze inflation out of the economy.

This interaction between Fed and Congress on monetary policy has been very constructive. I feel it will go a long way in the direction of reducting inflation pressures.

Some bond market participants have said, "Well, the Fed will chicken out. Fiscal excesses will finally put so much pressure on the Federal Reserve, they have to cave in. Politics are politics. They can't hold the line forever."

They haven't in the past, to be sure, but I want to suggest to you today, Mr. Chairman, Senator Nunn, Senator D'Amato, that Fed Chairman Paul Volcker is in it for the long term. He has convinced me, as a market participant, that he means business. He has cut money growth in 1981 down to 3½ percent, essentially starving the community for credit.

Unfortunately, that starving is felt more in the case of small business than it is in the big business area. We will talk about that in a minute. But Chairman Volcker has made his point, and for next year, the handwriting is already on the wall. The Federal Reserve has established a money supply target of about 4 percent for next year, very low growth.

These numbers are barely half as much as we normally had in Fed money growth in other periods, such as 1976. So I don't think we have to debate any longer, Senators, in my view, whether or not the Federal is going to give in.

In my opinion, the Federal Reserve, is if anything going to be too rigid, as it seeks to atone for earlier easing excesses, such as in the second quarter of 1980 when it is generally acknowledged that the Fed eased too fast and too far.

A second factor operating to hasten the impending clash between tight money and a loose fiscal policy is still a vigorous and largely interest-insensitive spate of private credit demands. The business sector has not yet stopped borrowing. We see that in loan figures. You can look at bank loan demand, you can look at commercial paper borrowing by businesses. Both tell you the same strong-demand story.

There are some business who are continuing to borrow. The question is who are they? They happen to be the largest businesses, companies like Mobile Oil who are in the process of mergers or acquisitions. It just so happens that bankers desire those big loans because they tend to have floating rates on them. They are very happy to make the loans to the big businesses since these loans have floating interest rates that relate to floating costs of bank time deposits and other liabilities on a short-term basis.

The only problem is that this is essentially another form of crowding out the losses are smaller businesses, mortgage borrowers, and maybe even State and local governments, as we look down the road in the face of these very scarce new money and credit growth levels.

In addition to the merger demand for loans there is another more troublesome demand for loans as we look ahead. I am deeply concerned, Mr. Chairman, over the possibility that we will have a period of 3 months or so of nervous demand or concerned demand on the part of businesses who can't do anything else but continue to borrow as they are squeezed, as their cash flow is drawn down, as the inventory is temporarily built up on the shelves.

That is panic demand for money. It is not solid, fundamental demand based on growth in the economy.

The latter type of loan demand, by the way, is similar to the British experience, the "Thatcher's disease." It is the problem where you have tight money, you have a lot of government borrowing, and in the middle of it, you have paniky business borrowing. Through most of this British experience we have seen their poor businesses who have had to borrow to stay alive. The clash has produced very high interest rates.

We are, at this moment, exactly in the same kind of conflict. Credit demands have already remained high because the underlying rate of inflation is high and because we have continued to see heavy demand based on the fact that wage settlements were high, and workers continued to keep them high based on expectations of inflation.

There are other kinds of index and financial problems, so the problem at this moment is that credit demands are still too high even on the big business side.

Where are we headed is really the issue here. Not so much where we have been, but where are we going.

My own feeling is that the recession signals are flashing very strongly at the moment for the economy because of an extended period of high real interest rates. In fact, the highest interest rates, even adjusted for inflation, since the birth of Christ.

The German Chancellor, recently in Canada, stole that comment perhaps from us. The U.S. economy is perhaps a better illustration than the German economy of this reality. The economy is headed into recession, as I see it. Indeed, recession may have already started in August or September, and it could last until May or June of next year. So the economy is moving lower.

We eventually will see, I feel, against the background of that decline, a pullback in private credit demand. It will be the ultimate crowding out.

What we will have seen is tight money clashing with heavy Government spending and this will actually and finally force business borrowers, mortgage borrowers, State, and local governments, to some degree to their knees and out of the markets.

That will lead to a possible severe economic recession.

I look for growth in real economic activity in the fourth quarter of 1981 not to be up as the administration had hoped, but to be down 3 to 4 percent.

I look for real growth in the first and second quarters of next year not to be up as the administration hoped, but to be down again in each quarter.

I look for the third quarter of 1982 to be very flat. At best, the economy may start to show some signs of life in the fourth quarter of 1982, but that is by no means assured at the present time.

A final point about this recession. It is critical in the sense that it is in unchartered territory. It is not an old fashioned inventory recession which economists used to like to talk about in which you could simply predict a sharp drop in inventory and then some pick up. That was all very neat, and we have computerized that.

This is a grassroots business recession which has no precedent in history. The small businessman and the consumer are caught with high short-term debt and high interest rates, and the potential squeeze is severe.

Finally, with respect to the budget as a final and significant credit demand factor, I look for the following in terms of budget numbers for 1982, 1983, and 1984: It appears that the Federal budget deficit in 1982 will probably be as high on a unified basis as $75 to $85 billion even allowing for the President's second round budget cuts.

The administration says $43.1 billion is likely to be the number. In view of the possibility of recession and sharp drop off in tax receipts that deficit could rise on a unified basis to $75 to $85 billion.

Senator NUNN. May I ask you one question? What growth rate are you projecting, real growth rate, when you get that $85 billion?

Dr. JONES. For calendar 1982?

Senator NUNN. For fiscal 1982.

Dr. JONES. I am forecasting essentially on a calendar basis, but what I am looking at is less than half a percent real growth in 1982.

If you put it in administration terms, I am looking for less than one-half percent compared with the administration's 5.2 percent.

Senator NUNN. Thank you.

Dr. JONES. Let me conclude, if I might, with my recommendations.

Historical experience suggests that there is no quick or painless way for the United States, or, for that matter, any other country, to unwind from a decade of mounting inflation psychology and speculative excess. However, the difficult transition to a less inflationary state can be greatly aided by coordinated economic policies of monetary and fiscal restraint. With Federal Reserve policy seemingly on a no-return course of severely limiting new money and credit growth, there is no escape on the fiscal side.

Congress is, at this point, faced with a stark choice. Either it establishes credible Federal budget restraints to assist the adjustment to a less inflationary economy, or alternatively, consumer and business borrowers will be crowded out of the financial markets and the economy will collapse.

The ball is now in Congress court. Recommended actions include the following items. Congress should:

Make every effort to hold total Federal Government spending for fiscal year 1982 in the vicinity of $710 billion, and it should make future budget tightening the overriding legislative priority. And in this respect, I would emphasize that further tax cuts should be tied directly to spending cuts.

It was wrong for the administration to lock in that tax cut for 3 years and to decide on spending cuts only on a year-to-year basis.

Second, Congress should take the initiative to determine the proper allocation of funds within appropriate spending limits, between defense and nondefense priorities.

In other words, Congress should work somewhat independently of the administration on this issue.

Third, Congress should search for Federal revenue sources including a possible $5 a barrel tax on imported oil—which would raise an estimated $10 billion in additional revenue in fiscal year 1982—and increased excise taxes on tobacco and alcohol.

Fourth, Congress should encourage additional industrial deregulation so that excessive wage cost pressures may be eased, as has already been the case in the airline and trucking industries.

Congress should set up voluntary industry income guidelines that seek to link wage increases to productivity gains.

And finally, Congress should commend the Federal Reserve for reestablishing anti-inflation credibility, and advise the Reagan administration to stop meddling in the Fed's business of specific techniques of monetary control and the appropriate current Fed policy stance.

Thank you.

Senator WEICKER. Thank you very much.

[The prepared statement of Dr. Jones follows:]

"The Financial and Economic Implications of Prolonged Tight Money and Loose Fiscal Policies"

Testimony by

Dr. David M. Jones
Vice President and Economist
Aubrey G. Lanston & Co. Inc.

Before the

United States Senate
Committee on Small Business

October 14, 1981

Federal Hall
New York, New York

The U. S. economy is in a period of deepening crisis and vulnerability. This crisis--which is far more profound than many realize--will test us all in the months ahead. The seeds of this crisis have been sown in a viciously accelerating process of inflation and inflation psychology in the past decade or so. Although this inflationary binge owes much to outside forces such as the world food crises of 1972 and 1980 and the oil price shocks of 1973 and 1979, the real "engines of inflation" have been excessively accomodative monetary and fiscal policies.

It is now time to pay the piper. However, the transition to a less inflationary economy requires a change in the mentality of inflation on the part of consumer and businessmen alike. The issue is whether this transition will be harsh and damaging, involving a prolonged period of high interest rates, widespread bankruptcies, and a deep economic recession, or whether it will be a shorter-term process involving a soft landing in economic activity.

The first ingredient of the shift towards a less inflationary economy has been the application of monetary discipline. The Federal Reserve, in an increasingly successful effort to establish anti-inflation credibility, has set out to deliberately starve the economy for new money and credit in 1981 and 1982. However, this tight money stance is currently clashing violently with the loose fiscal policies of the Reagan Administration--including the 3-year tax cut and sharply increasing defense spending. It is this dangerous and unstable economic policy mix--to be feared just as much as an unstable or volatile scientific mixture of chemicals-- which has been behind the August-September shock wave through the bond and equity markets. The simple fact is that monetary discipline has to be accompanied by fiscal discipline if the transition to a less inflationary economy is to be relatively smooth and lasting.

The August-September fears of the thousands of buyers and sellers putting their money on the line in the bond and stock markets centered on the prospect that the clash between prolonged tight money and loose fiscal policies could keep interest rates at or near record levels for yet another year or more. The harsh reality--particularly for small businesses (and even many larger ones), for mortgage borrowers, and even for State and Local governments--is that they may be shut out of the financial markets completely or that they may get no more then the tag ends of the increasingly scarce new money and credit supplies, once the greedy Federal government inevitably elbows its way to the head of the line of prospective borrowers. With such "crowding out", there would be widespread financial failures and bankruptcies--already running in 1980 at twice the rate of 1979.

Unfortunately, in this situation of increasing friction between the Federal government and other borrowers,the only longer-term relief from financial strains would come with a sharp resulting drop in real economic activity, accompanied by rising unemployment. In this case, business borrowers would--after a temporary period of frantic borrowing in anticipation of a feared crunch, or to enhance strained liquidity positions, or to cover involuntary inventory buildups--pull back,leaving the Federal government to borrow largely in a vacuum.

Federal Reserve Credibility

The monetary authorities have set out to deliberately starve the economy for new money and credit over an extended period in order to crush inflation and inflation psychology. This prolonged Fed restrictive resolve stands in marked contrast with much more accomodative Fed policy actions in earlier comparable cyclical phases which, though potentially inflationary, obscured a multitude of fiscal excesses. In line with its current restrictive intentions, the Fed has set a tight 3 1/2% target for money supply (M1-B) growth in 1981 (the lower limit of an official 3 1/2-6% target range). For 1982, the Fed's preliminary target is nearly as restrictive at 4% (the mid-point of the official 2 1/2-5 1/2% target range).

These targets are likely to have a depressing effect on real economic expansion, in view of the still high 8-9% underlying rate of inflation. Fed Chairman Volcker underscored this reality in recent Congressional testimony in asserting that real economic growth in 1982 might turn out to be no higher than half the Administration's 5.2% goal.

Some observers have wrongly concluded that the greatest near-term threat to the bond market is that the monetary authorities will be, as in the past, too quick to cave into the pressures of fiscal excesses, thereby planting the seeds for future accelerating inflationary pressures. The more plausible near-term threat is, however, that the Fed will be not too easy but too rigid, as it seeks to atone for earlier easing excesses, such as in the second quarter of 1980 when it is generally acknowledged that the Fed eased too fast and too far.

The result could be a financial crisis. In this event, the impact will fall the heaviest on corporate, municipal, mortgage and other borrowers seeking to borrow on a longer term basis at a fixed interest rate. This could turn out to be a "sneaky crunch" in which large, low-risk corporations borrowing on a short-term basis can raise all the money they want while high-risk municipal, mortgage, or small business borrowers may be shut out completely.

Persistent Private Credit Demands

A second factor operating to hasten the impending clash between tight money and a loose fiscal policy is a still vigorous and largely interest-insensitive spate of private credit demands. These demands, which have been sparked by lingering inflation psychology (as well as tax advantages for borrowers), have most recently been evidenced by heavy business borrowing for merger or corporate take-over purposes. Banks, in contrast with earlier periods of Regulation Q-induced disintermediation, have generally welcomed such short-term business borrowing demands because they fit into spread financing programs. These programs involve the matching of variable rate liabilities (such as CD's, money market certificates, and RP's) on which banks have become increasingly dependent, with variable rate loans. Other areas of persisting strength in business loan demand are oil, high technology and defense.

A third and closely related factor contributing to the conflict between tight money and unsatisfied credit demands is a high underlying inflation rate. Primarily because of multi-year wage contracts based on expectations of a continuation of earlier inflationary excesses, along with similar arrangements serving to lock in inflationary trends, the underlying inflation rate currently remains at 8-9%. This institutional inflation factor tends to sharply expand consumer and business credit demands, even in periods of sluggish real economic activity. As a result, the Fed-induced tight money strains are more severe than otherwise would be in the case and the crowding out of needy private borrowers by the funds-hungry Federal government can be potentially more acute. Adding still further to near-term business credit demands are likely to be liquidity strains and inventory problems arising from slumping economic activity.

A flurry of recent economic signals have been flashing slowdown including the rise in the September unemployment rate to 7.5% from 7.2%, weak September auto sales, negative expectations on the part of corporate purchasing agents, and declining consumer confidence. Also there have been August declines in leading indicators (the third decline in the past four months), new home sales, construction spending, and manufacturers new orders.

On balance, it appears that a recession may have started in August or September of 1981 and could continue until May or June of 1982. Such a development could be accompanied by a surprisingly large declines of 3-4% in real GNP in the final quarter of 1981. Additional declines in real GNP are possible in the first and second quarters of 1982.

Dismal Federal Budget Prospects

Even with the President's latest budget proposals, it is possible that the Federal deficit in fiscal year 1982 will soar as high as $85 billion far exceeding the latest official estimate of $43.1 billion. These Federal borrowing needs are further inflated by an additional total of about $15 billion for off budget borrowing and, no doubt, a still larger borrowing needs by the Government sponsored corporations. The confrontation between this fiscal imprudence and tight money would seem to make a financial crisis inevitable unless Congress takes prompt action.

Contrast With Earlier Periods

The potential for an increasingly severe clash between tight money and a loose fiscal policy stands in marked contrast with earlier periods of comparable economic sluggishness. In the modest 1976 recovery, for example, the budget deficit was nearly $70 billion, but Fed policy was considerably more accomodative. Specifically, M1 growth in 1976 was 6-7%, nearly twice the Fed's 1982 target. At the same time, the underlying inflation rate was, at least by comparison, a very modest 5-6%.

With plenty of new money and credit to go around in 1976, corporations were able to strengthen their balance sheets by borrowing in the longer-term bond market and using the funds to repay their excessive short-term debt. Unfortunately, few corporations have had this option in 1981, in light of disorderly bond market conditions. The resulting deterioration in corporate balance sheets raises the possibility of widespread business bankruptcies. In the event that some major commercial paper borrowers might falter, difficulties might spread to, say, money market mutual funds, which hold significant amounts of commercial paper and other unsecured debt. In addition, there is, of course, the possibility of failure among thrift institutions and perhaps even some banks should interest rates continue at record levels for another six months or more.

Meanwhile the only temporary relief from already severe financial strains has come with the Fed's move to step-up bank reserve growth over the July-October period, with a view to bringing lagging M1-B growth back up to its 3 1/2% target for this year. This easing action has been accompanied by limited 1 percentage point reductions in the Fed's discount rate surcharge on large banks borrowing too frequently in both September and again in October. There is, however, unlikely to be an extended period of Fed easing action in view of the Fed's tight annual money target.

Recommendations

Historical experience suggests that there is no quick or painless way for the U.S., or, for that matter, any other country, to unwind from a decade of mounting inflation psychology and speculative excess. However, the difficult transition to a less inflationary state can be greatly aided by coordinated economic policies of monetary and fiscal restraint. With Federal Reserve policy seemingly on a no-return course of severly limiting new money and credit growth, there is no escape on the fiscal side.

Congress is, at this point, faced with a stark choice. Either it establishes credible Federal budget restraints to assist the adjustment to a less inflationary economy, or alternatively, consumer and business borrowers will be crowded out of the financial markets and the economy will collapse.

The ball is now in Congress' court. Recommended actions include the following items. Congress should:

- Make every effort to hold total Federal government spending for fiscal year 1982 in the vicinity of $710 billion, and it should make future budget tightening the overriding legislative priority.
- Take the initiative to determine the proper allocation of funds within appropriate spending limits, between defense and nondefense priorities.
- Search for additional Federal revenue sources including a possible $5 a barrell tax on imported oil (which would raise an estimated $10 billion in additional revenue in fiscal year 1982) and increased excise taxes on tobacco and alcohol.
- Encourage additional industrial deregulation so that excessive wage cost pressures may be eased, as has already been the case in the airline and trucking industries.
- Set up voluntary industry incomes guidelines that seek to link wage increases to productivity gains.
- Commend the Federal Reserve for reestablishing anti-inflation credibility, and advise the Reagan Administration to stop meddling in the Fed's business of specific techniques of monetary control and the appropriate current Fed policy stance.

Senator WEICKER. Dr. Yardeni, chief economist of E. F. Hutton.

STATEMENT OF DR. EDWARD YARDENI, CHIEF ECONOMIST, E. F. HUTTON, NEW YORK, N.Y.

Dr. YARDENI. Thank you, Senators, for inviting me to address you today. My name is Edward Yardeni, and I am the chief economist for E. F. Hutton.

In the interest of time, I will keep my remarks short.

What I will do today is give you an idea of where I think we are, where I think we are going, and what my policy assumptions are.

First of all, I think earlier this year, the consensus forecast on Wall Street and in other parts of the country was that interest rates were going to gradually decline over the year.

A lot of businessmen were already in trouble starting early this year once the prime rate got back to 20 or so, but being aggressive optimists, as one of your panelists said earlier today, they hung on hoping that rates would drop and that would bail them out.

Then, something very strange happened. In July and August, economists and others realized that rates were still high. Maybe rates are not coming down after all, and maybe they are going to stay higher longer. The longer the interest rates stayed at their high levels, the greater the risk of a financial crisis.

In other words, lenders would only want to lend to top corporations, they wouldn't want anybody else. They wouldn't want to give credit to the small businessman.

I think the concern was that if interest rates were going to stay higher longer, then we were toying around with a potential for a financial crisis, and then a very widespread economic recession.

Well, you see as that consensus revealed, rates weren't going to come down as anticipated. Forecasters do have a tendency to overreact to their past mistakes, and some of us felt, well, maybe rates could even go higher.

And suddenly the forecast that the prime rate could go 25 percent sometime before yearend became very credible.

Well, we saw what happened in the stock and the bond market. People were saying, "Why am I in bonds or stocks if I get some 18 percent in a money-market fund for some time to come."

I think in the business community, many businesses could count the number of months, weeks, or days, to bankruptcy at current levels of interest rates, and a lot of them simply said, "I am not going to wait until I go bankrupt. I am not going to wait for a financial crisis to put me out of business. I am going to cut back today."

And so, the indicators that I look at suggest to me that the economy dropped off a cliff at the end of September, and we have been in a recession in my mind since April.

We are seeing the final stage of that recession now. I think that the worst of it will occur between now and the end of the year. Typically in an unanticipated recession, the biggest layoffs and the biggest increases in unemployment occur at the end of any recession, and I think we are in that stage now.

I think by February or March or so, there will be some elements of a recovery, but it will be a very, very sluggish recovery. That is all the bad news.

The good news is that in that kind of environment we will see further drops in interest rates. I think we will see the prime rate at 15 percent by the end of the year. By February, it could be down to 12 percent. I think that we will find that the inflation outlook will continue to be very, very promising.

Maybe this will work to the Republicans' advantage in the congressional elections—I don't know. I know that one of the things that I would fear if I was a Republican and I was running for Congress is to find that my Democratic opponent was asking the voters, "Are you better off today than you were before the President took office?"

I think the bond market clearly has been hampered for several years. There is a lot of pessimism there. But a few more months with a recession and with labor concessions on wages next year, I think there will be increasing credibility in the Reagan program. I think the bond market will become receptive again to new issues. I think that could last until the end of next year, if not beyond that.

I am a secular optimist. I think we are about to see a secular decline of interest rates.

Now, the policy assumption behind my forecast is that both on the budget and the tax side, nothing more will be done. I can't really see Congress coming up with more defense cuts.

The Middle East situation is clearly lighting up with problems in the Sudan. So, I think it will be politically very difficult to get larger defense cuts. Clearly, a lot of bond investors would like to see not the $3 billion cuts in defense, but $10 to $15 billion in fiscal 1982, and certainly beyond.

I don't think that is going to happen.

Another thing that bond investors would like to see is a rollback of the tax cuts. In their heart of hearts, they would like to see the tax cut eliminated entirely.

Further, they would like to see either a cutback or deferral of the tax cut.

Again, I don't think that it is entirely feasible. There is really little that I am expecting Congress to do or actually would suggest they can do here. I think the recession itself will take a lot of pressure off on interest rates.

Unfortunately, there is not much that can be done at this point to help a small businessman. The damage has already been done. We already see the bankruptcy rates rising. We know that as the recession gets more severe, probably more businessmen will get hurt in the environment. It is simply too late.

The interest rate structure has already done its damage. The psychology has already moved into a recession mode. I think the thing to do is let the recession do what it typically does: Allow rates to drop, open up the bond market, allow businesses to refinance their short-term debt in the long-term market. Then let's hope that the Fed isn't politically panicked into being too loose in the recovery. Because in the final analysis what bond people have learned over the years is that we don't lose the fight against inflation in the recession. We lose it in the recovery.

We are so paranoid about the pain of the recession that we overstimulate. Most bond investors I talked to aren't really rooting for a widespread recession because that doesn't help anybody. They are simply rooting for a very sluggish recovery. One in which inflation remains low. One in which confidence is rebuilt. I think with a little bit of patience we might see a better economic environment in the next year, and in fact, I think in the second half of next year, we could have some vigorous economic growth with low inflation, and believe it or not, interest rates should stay low compared to current levels.

So those are just some thoughts for you, and I would be happy to elaborate on any of them, those things, in the question period.

Senator NUNN. Mr. Chairman, just one question before he leaves this point.

You gave us your assumptions on what Congress would do, which was virtually nothing, but what was your assumption about the result of Congressmen virtually doing nothing as far as the 1982, 1983, and 1984 deficits are concerned?

Dr. YARDENI. I am not an optimist on the deficits. I prefer to look at financing needs.

The Treasury will be coming to market in fiscal 1982 with anywhere between $80 and $100 billion.

I don't really expect the balanced budget by 1984. If politically we can't do it, maybe we should just admit that we are not going to balance the budget by 1984. We are going to make progress toward the balanced budget, but given the political constraints, we won't make it by 1984.

Senator NUNN. Mr. Harbeck, if you take those same assumptions—that is, Congress doing nothing at this stage, which I know is not what you advocated, but if we follow a course in 1982, no balanced budget anywhere near 1984, what do you predict for the economy?

Mr. HARBECK. Senator, I think interest rates will stay high. I think that $80 to $100 billion will show up in the bond market in terms of increase in demand for funds, and there are a number of other borrowers who have been unable to finance at these levels. I am talking about your B.A.A. rated utilities who would have to finance at better than 18 percent who have simply been pushed out of the market at the present time.

Their demand for funds is still there. They simply did not finance. If interest rates were to start coming down, I believe that they would come back in the market, and that supply in the private sector would build back up.

Senator NUNN. Dr. Jones, could I ask you the same question. I just want to get this common set of assumptions here to see what you project if that happens.

Dr. JONES. My budget deficits for 1982 were $75 to $85 billion——

Senator NUNN. Not much different from Dr. Yardeni.

Dr. JONES. But that is only unified.

Of course, there are o-budget items of another $20 billion—I would be simply higher than he would—that get into the picture.

Senator NUNN. What I am really asking you is what you think the economy would do, if Congress did nothing, virtually nothing now, and whether we would have the kind of deficits that he predicted over the next 3 years.

Dr. JONES. My own feeling would have been that the tendency would be for interest rates to remain higher than we can stand, certainly through the first half of next year, and against the background of a weakening economy. That is the British disease, in effect.

Businesses have to borrow to stay alive.

Government is borrowing too much. And Federal Reserve policy is tighter than it has ever been.

Senator NUNN. What will the economy do in this case?

Dr. JONES. We will see virtually no growth in 1982, compared to the administration's estimates of 5.2, and we will only gradually stumble out of the recession toward the end of 1982 and 1983.

Senator NUNN. I think there is already a serious prolonged recession.

Dr. JONES. There is a dangerous element of recession right now. Like my boss back at Aubrey Lanston says to me, he says, "Jones, don't give me this economic stuff a year from now. Just tell me what is going to happen in the next week."

Now, I don't want to be too short term here, but the vulnerability in this economy is over the next 3 to 6 months in my view, and it is in this time frame where we should look very closely about doing something. This is where I would offer the possibility of some revenue, oil import tax, or something of that nature. But given the difficulties in cutting back spending, it is that time frame that is the most dangerous for this economy, and I would say the economy is in a more vulnerable period than at any time in the post-World War II experience.

Senator WEICKER. About the vulnerability of the economy in the next 3- to 6-month period——

Mr. HARBECK. Senator, interest rates have shown an incredible volatility over the last 3 or 4 years. They are more volatile than they have ever been.

Last year, we saw a drop in short-term rates of over 1,000 basis points over a few months' period of time.

It is possible that we will get a drop in rates triggered by the desire on the part of some people to buy bonds, triggered by nervousness, panic, and so on.

It is impossible, I think, to predict where interest rates will go over the next couple of months. They will swing back and forth with tremendous velocity, but long-term bondholders who are looking down the road quite a bit, I think, would be disappointed if they bought into this rally with the idea that they can hold on to these bonds for very long and make a profit with them.

Senator WEICKER. This committee is a small business committee, it is not a banking committee, and it is not the Judiciary Committee. It is the Small Business Committee, and the small businessman has been in a squeeze now for quite a period of time, both as to availability of capital and what he has to pay for that capital.

This is in the area of the last several months.

Indeed, if you talk to the homeowner, they have been in a bind of probably close to 2 to 3 years in that situation.

We have had testimony about that by the head of the real estate board in Connecticut. She said they only got out of the recession or wherever it was for them, 1975, 1976, 1 good year in 1977, and then went right back in the soup again where they have been since that period of time, and the difficulty is that you are correct that bankruptcy subsisted as you say, but I think you will find a progression upwards for even a longer period of time back. These people can't hang on much longer. We are talking hopefully they will come out of it at the end of 1982.

I just would like to know what the statistics are going to be by the end of 1982 as to who has gone belly up.

Mr. JONES. Mr. Chairman, could I add to that?

Sentor WEICKER. I want to say one thing.

As you can tell from the question, we are not here to jawbone or whip Wall Street, and I couldn't agree more that is where the truth lies. That is not the point.

The point is, there are many factors, and Wall Street is not the reason for your present difficulties, but having said that, even though I am disappointed for bondholders and stockholders, and I probably fall in that category, we will make it through, even though maybe we aren't going to have any extraordinary capital gain.

On the other hand, the guy that I am talking about is out of business, out of business, out, dead. That is what concerns me. I don't think that he is an acceptable price, as far as I am concerned.

Dr. JONES. Just to expand on your remarks, Mr. Chairman, I have never seen a wider gap between the depressed reality for the small businessman in the trenches, so to speak, and the deceivingly strong broad numbers, that is, retail sales, production, and so forth, that our economic policymakers are getting in Washington. There is an unusually large gap between figures like retail sales and other kinds of cold, hard economic facts and the plight of the businessman on Main Street.

You see, Chairman Volcker is saying inflation must be crushed and as I suggested in my testimony, he has taken a fine stand on inflation. The anti-inflation medicine is very painful. He is saying in effect, however, that it must last longer because retail sales were just up. Everyone thought they would be down. But at the same time when I speak around the countryside or talk to people on the firing line or down in the trenches or particularly the small businessman, they have again never seen it so bad. So, in my view, something has to give in terms of that gap between the depressed realities on Main Street and the broader signs of a still-resilient economy.

My guess is that it is the guy down in the trenches who is really calling it the right way, and that's where I see the vulnerability in the next 3 to 6 months. And perhaps this vulnerability will continue through the end of this year and into early next year. But I don't think this is an easy turn around job because I think it is a grassroots recession.

We don't have precedent for the kind of recession we are getting into here. This is not a simple computer recession in which fancy economists throw together a fancy model and give you a neat forecast.

This is happening on Main Street, U.S.A., and it is very dangerous, and it makes the economy very vulnerable.

Senator D'AMATO. Dr. Jones, given your scenario you feel that we are in one of the most vulnerable times economically since World War II. What course of action would you propose to ameliorate some of the difficulties that we face right now?

Dr. **Jones.** That is the most difficult part because in essence, the die has been cast, I think.

Senator **D'Amato.** If there were, for example, deferral of the second part of the tax program, the 10-percent cut, saving $7.4 billion, would that, coupled with some form of budget cutbacks, suffice? Does that begin to deal with the magnitude of the problem that you describe?

Dr. **Jones.** Not really, for two reasons: One, is that one feature of the untested supply-side economics that we have seen from the administration is the fact that we can look with some degree of confidence on a 3-year cut or the businessman can look with some degree of confidence on a 5 or 6 year accelerated depreciation allowance. It would be wrong to change those tax cuts after all of the high visibility given to them. Such a move would create possibly more uncertainty or more difficulty than it would do good.

The second thing is that there is an economic logic perhaps, to a full 10-percent cut July 1, 1982.

The July 1 date may be appropriate for economic reasons. The tax cut should come if my guess about the economy being as weak as it is, is correct. So my feeling would be you can't do something as dramatic as that without creating perhaps too much uncertainty and that outweighs the benefits you get.

I do simply say that Congress has to create credibility on the spending side. And another point I would like to make is if it is true we are headed into recession, it is not a good idea to continue to cut budgets. That could be Hoover economics, going back in history, cutting spending as we move into recessions.

I would say, Congress should take a stand on the existing spending levels and should guarantee this to the public. And also maybe there could be some revenue stopgaps such as an oil import tax that would close a little bit of that deficit in, but I don't see something as significant as a tax cut delay being the appropriate course.

Dr. **Yardeni.** I think politically I just don't see where you are going to come up with more spending cuts. It seems to me that you have gotten about as much as you are going to do, and I thank that although my policy assumption was that Congress will do nothing, I think that if the will can be mustered, I don't really think it would be a horrible gotten about as much as you are going to do, and I think that although loss of face to say, "Look, we made a mistake. We were a little bit more ambitious. We were trying to do too many things at one time."

To have the Federal Reserve without monitorism, to have it deregulate the Federal system, to have Congress cut spending and then cut taxes, do all these things at one time is bound to lead to some structural disproportions in the economy, and I think what we all can agree on is if there is one disproportion that we can probably correct it with the least amount of disturbance to the finanical market and to the economy, it is probably to scale back that tax cut.

So I think that in many cases, the most important voters right now that all Congressmen have to address is bond investors because the thing that really worries me—I really do agree that we have got a window of vulnerability here in this economy, and I think that the thing that worries me is, if inflation didn't get you to buy bonds, what if recession numbers don't get them to buy bonds?

I mean in the past, recessions have always worked at least in getting a temporary rally, and if that doesn't happen, then you are really talking about a very severe recession. It could last much longer than I think, and certainly as long as David thinks, might even be longer than that.

I think that the way, that one of the things that you can do to impress bond investors aside from, I think, supporting the Feds at this inflationary course is to say, "Look, we made a mistake. We tried to do too many things at one time. The tax cuts and the budget cuts have really just exacerbated the problems."

Senator NUNN. What would you say of the proposition that the individual tax cuts of 1982 and 1983 would go into effect to the extent that we made spending reductions from the current policy level?

In other words, instead of an automatic $45 billion tax cut in 1982 and another approximately $45 billion automatic tax cut in 1983, those cuts would take effect only to the extent that they were matched by spending cuts achieved in the preceding budget reconciliation process.

Dr. YARDENI. I think that would be very helpful. I think that would certainly help.

Senator NUNN. Dr. Jones, what do you think?

Dr. JONES. I would very much agree with that, Senator Nunn. I think that is an excellent compromise solution to the problem.

Again, some uncertainty, but perhaps at least establish fiscal credibility in a way it has never been established before.

Senator NUNN. The uncertainty would then shift. The uncertainty would then be the size of the tax cut instead of being the fiscal policy of Congress.

Dr. JONES. Precisely.

Senator NUNN. Mr. Harbeck?

Mr. HARBECK. Mr. Chairman, let me respond to your inquiry a minute ago about what possibly could be done for small businesses. Two very innovative ideas have surfaced from the Government in recent years. One was the Ginny Mae proposal, which enabled institutional buyers such as myself to buy packages of private mortgages, and the other, of course, are the SBA guaranteed loan to small businesses.

I have purchased both of those securities. I think that an expanded program of SBA guarantees by the Federal Government would certainly induce people like myself to take another look at that area of the market.

Senator WEICKER. I appreciate your comments very much.

Mr. HARBECK. They are supplying credit and they are helping small businesses, and while they are not terribly marketable, the yield is commensurate with other yields. I think that you will find some institutional support for those type of securities.

Senator WEICKER. Gentlemen, I would like to thank you very much for being with us. I want to tell you, you certainly explained a lot of things to me. I think you immeasurably helped the committee's work. That is about as thorough and understandable a lesson as I have had in economics in a long time, and I want to thank you for taking time from your very busy day. I appreciate it.

[The attachment to Dr. Yardeni's statement follows:]

ECONOMICS ALERT

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October 9, 1981

- ***Recession Mechanism Is in High Gear.*** The consensus economic forecast finally matches ours: real GNP should decline during this year's third and fourth quarters. We expect a drop of 3% to 4% during each of these two quarters. Until recently, most forecasters expected a flat third quarter followed by 2% growth during the year's final quarter. But now they see that business activity isn't as resilient to high interest rates as earlier believed.

  The latest batch of labor market indicators supports our recession forecast (see following two stories). Earlier this year, many businessmen, squeezed by the high cost of money, decided to hang on, hoping that an imminent and sharp drop in interest rates would bail them out. That's why business activity remained surprisingly strong this summer despite a 20% prime rate. Then, in July and August, the consensus interest rate forecast took an about face: interest rates would remain high possibly into early next year. Many economists feared a credit crunch and still higher borrowing rates. But businessmen weren't going to wait for a financial crisis and a 25% prime rate to put them out of business. Thus, in August they started cutting employment and production. That's confirmed by the weekly initial unemployment claims data and the recent survey of purchasing managers.

- ***Purchasing Managers See Recession.*** As you know, initial unemployment claims data are among our favorite forward indicators of economic activity (see following story). We've recently experimented with another set of indicators which also have an excellent record of signalling turns in the economy. We constructed these indicators from survey data collected by the National Association of Purchasing Managers (NAPM). Since the 1930s, this trade group has been conducting a monthly survey of managers who purchase raw materials and goods for their companies.

  We derived a series we call the *NAPM Employment Index* by subtracting the percent of respondents reporting lower employment during the month from the percentage reporting higher employment (Chart 1). Similarly, the *NAPM Production Index* equals the percentage reporting better production activity less the percentage reporting worse production during the month (Chart 2). We seasonally adjusted both indexes.

  The NAPM Employment Index is highly correlated with the one-month change in payroll employment (Chart 1). The payroll employment data are collected by the Labor Department early each month. The survey of purchasing managers is conducted late each month. In September, payroll employment edged down by 54,000 and was about unchanged from the levels of the previous two months. This stability was in marked contrast to the job increases registered during the first half of the year. *The latest NAPM survey suggests that payroll employment declined sharply in October, perhaps by over 200,000.* Of the industries surveyed, only 5% reported higher employment at the end of last month, down from 16% in August, and the lowest level since the 1973-1975 recession. The seasonally adjusted September NAPM Employment Index fell to –18% from –2% in August.

  The September NAPM Production Index suggests that industrial production fell by 1% or more during the month (Chart 2). A similar decline in October is suggested by the two NAPM indexes.

- ***Layoffs and Unemployment Claims Confirm Recession.*** Manufacturing layoffs increased dramatically in August to 1.5% from 1.0% in July. Layoffs are highly correlated with initial claims for unemployment insurance. *The surge in initial claims during September to a weekly average of 488,500 from 425,400 in August suggests that September's layoff rate should climb closer to 2.0%.* During last year's recession the layoff rate peaked at 3.2% and initial claims hit a high of 635,000.

(More)

- ***Recession News Should Fuel Bond Rally.*** Since July, good news was bad and bad news was bad. At least, that's the way it was in the bond market. In our opinion, most of the economic news through year-end will be bullish. We expect that the good news will once again be good for bond investors. Even bad news doesn't seem to be so bad for bonds anymore. For example, bond prices held remarkably steady the day Sadat was assassinated.

  What sort of bullish news can we foresee? Virtually all the indicators for real economic activity should confirm our recession forecast over the next few months. The inflation statistics should also continue to support our disinflation story. The Fed is likely to allow the Fed funds rate to drift lower as the economy weakens. *We foresee a prime rate of 15% by year-end. We expect that long-term government bond yields will fall to 12½% by December.*

  Notwithstanding our optimism, bond investors should remain nimble. If the market responds positively to the next batch of weak economic indicators then we would commit more funds to the market. The market's response to the Treasury's November quarterly refunding package will also be an important test of its upside potential.

- ***Consumer Retrenchment Underway.*** As job losses mount over the remainder of the year, consumer spending is bound to fall. Consumers are already quite nervous. The September Survey of Consumer Attitudes conducted by the Survey Research Center of the University of Michigan found that the Index of Consumer Sentiment was 73.1, down 4.1 index points from August, and nearly equal to the 73.7 recorded a year ago. This confidence measure for families with incomes of $25,000 or more plummeted 11.7 index points in September. The attitudes toward buying conditions for durables, vehicles, and houses were much less favorable in the September survey than one month earlier: (1) favorable buying attitudes toward large household durables fell from 55% to 44%; (2) for cars, down from 43% to 34%; and (3) for houses, down from 21% to 15%.

  The reduced enthusiasm for purchasing cars was visible in the latest auto sales data. In September, domestic model sales equalled 6.7 million units at an annual rate, down from 8.2 million units in August. During September's final 10-day sales period only 5.5 million cars were sold. This depressed level was partly due to the lifting of the August/September rebate program. But this 10-day period also marked the beginning of the new model year. No wonder the auto industry is cutting back fourth quarter production to the lowest level since the final quarter of 1970, when GM experienced a strike.

  Attitudes toward the housing market in the September survey reached a new all-time low. A record level of 80% of respondents mentioned high interest rates as the main reason for their pessimism. In contrast to prior years, very few referred to housing as a good investment. According to the National Association of Realtors, existing home prices are now rising at a meager 5% to 6% year-over-year rate, compared to 15% to 20% in 1979 (Chart 3).

- ***Expect a Sharp Drop in September Leading Indicators.*** We expect September's index of leading indicators, to be reported October 29, to drop between 2½% and 3½% from August's level. The sharp decline in stock prices should push the index down by almost a full percentage point. The 0.9 hour decrease in the average workweek during the month should also push the index lower by another percentage point. The surge in unemployment claims during September suggests that the layoff rate should move close to 2%, up from 1.5% in August. Such a move would reduce the leading index by 0.5 percentage point. The September survey of purchasing managers suggests that the vendor performance component, which indicates the percent of companies reporting slower deliveries, should also be a negative contributor. Building permits should be down again.

Dr. Edward Yardeni,
Chief Economist
& Vice President
(212) 742-3811

EF Hutton

Chart 1

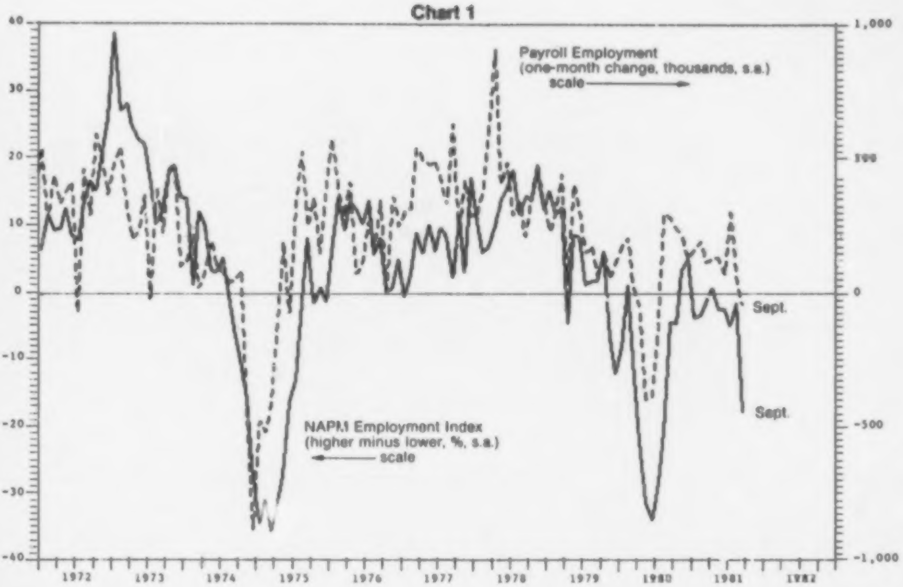

Chart 2

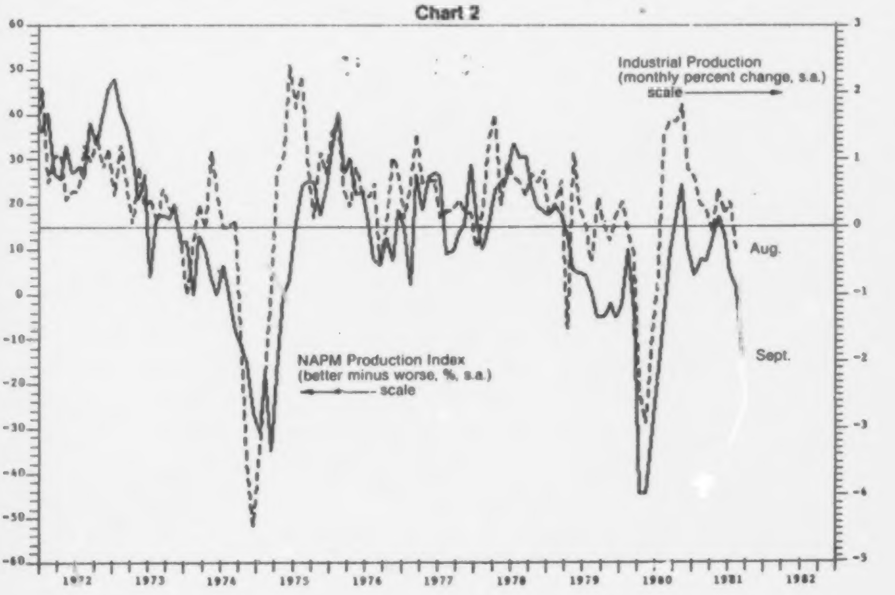

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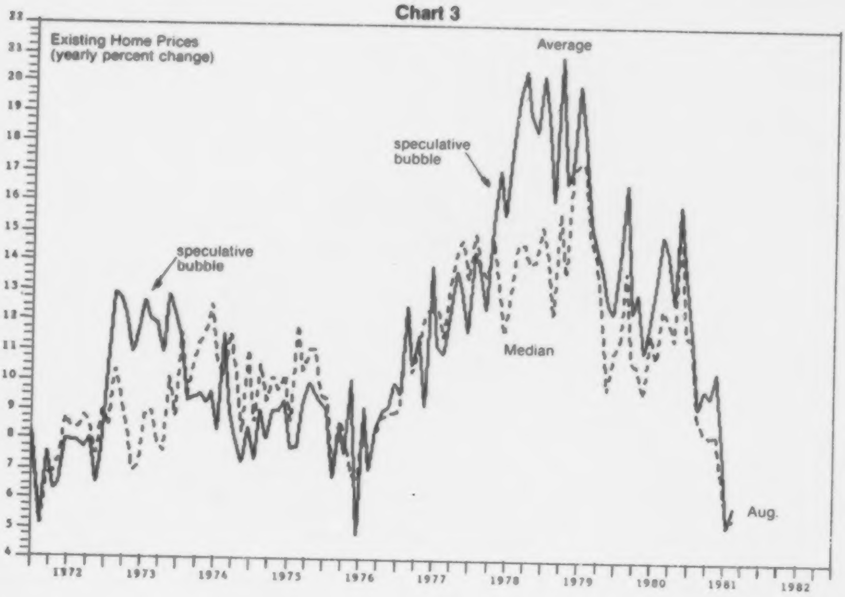
Chart 3



Senator WEICKER. Our last witness is Mr. Donald E. Maude, the chief financial economist of Merrill Lynch.

Mr. Maude, we didn't mean to leave you alone. We thought you were going to have a partner, but since he is not here, you have the table to yourself.

Mr. Maude, it is nice to have you with us. If you will proceed with your statement in its entirety, it will be included in the record, and you proceed any way that you see fit in its presentation and leave us a little time because I know we would like to ask you questions as we did the others.

STATEMENT OF DONALD E. MAUDE, CHIEF FINANCIAL ECONOMIST, MERRILL LYNCH, NEW YORK, N.Y.

Mr. MAUDE. Thank you, Mr. Chairman.

Mr. Chairman, Senator D'Amato, Senator Nunn, what I think we will do for expedition in this case, because I know this is running a little longer than you had planned, is to just submit my formal statement, and very briefly go over it and some charts that I have attached to it.

Included is also a transcript of testimony that I gave back in January of this year to the Senate Budget Committee. I think a lot of things outlined back then are just as appropriate now. As a matter of fact, probably more appropriate in light of subsequent events to bring home some key points.

Obviously, a lot of problems that we have in the economy relate to exceedingly high interest rates, and a lot of that relates right down to the perceptions of investors, and I think—I can very vividly, through a couple of charts and through a couple of tables, show you exactly what is on the minds of consumers and show you exactly why it has been so difficult to bring down interest rates and why, regretably, I feel it is going to be very difficult to bring them down over the foreseeable future, which could extend over the next year or so.

Let me just very quickly go to page 2, to just highlight some very critical long-term investments.

Just very quickly, if we look at the Federal side, I know this is something which is not new to you, but I think it is interesting when it is highlighted in the statistics and charts.

As you can see, when we look at the trends in the Federal Government's expenditures, they were running a very modest 4.3 percent annual rate during the first half of the 1960's. That represented a very relatively small 19 percent of total GNP.

During Vietnam, of course, they obviously did pick up. As we were financing the Great Society programs and the Vietnam conflict at the same time expenditures had started increasing at a 14.8 percent annual rate moving the amount of spending as a percentage GNP to 20.2 percent.

Interestingly enough, during the tail end of the Vietnam period and the first half of the 1970's, spending actually receded back to a 7.1 percent rate of growth and represented a 20.4 percent share of GNP.

If you look at the critical period from 1975 to 1980, government expenditures have experienced increases of 13.7 percent up to 22.1 percent and more recently up to 23 percent at an annual rate, keep in mind, we are looking at a period in which we had no new great society programs and no Vietnam conflict, and still the most rapid Government spending growth over the entire two decades was in the 1975 to 1980 period.

That was a period of peacetime. It was a period when we had no major welfare programs coming on the board, and it was also—and I think this is critical to keep in mind in terms of investors psychology—a time when we were promised balanced budgets in 1979, 1980, and onward, very much like the propositions of the hearing today.

If you look on page 4, you can see what the impact has been in the credit markets. You can see the trend line of greater Government borrowing from the credit markets to finance these deficits. We have been running in the red 17 of the last 20 years and you can see how it shot up over the 1970's.

There have been periods of declining Government credit market participation during recessions, but if you look at the trend line, it has been decidedly on the uptrack.

Just to highlight such a magnitude, the table on page 5 shows Government borrowing as percentage of GNP and as a percent of total credit market borrowings.

Along these lines, it is interesting to note that the troughs in terms of the Government's share of the pie in the 1970's are now higher than the peaks that we have had in the 1960's.

Let's take the second part of the table. During the peak borrowing period in the early 1960's, the Government was borrowing 14½ percent of the total credit market funds. We then went to a higher peak in 1967 of 15.3 percent to a higher peak in 1971 of 18.3 percent, and during the recession of 1974–75, actually close to 44 percent of all credit market borrowings.

The low point in 1979, close to 19 percent, by far exceeds the trough participation that we had in the 1960's.

Now, we can follow this line of analysis and the impact still further. On page 6, we can see that, if the Treasury is borrowing larger shares of funds, someone else has to be left out. That is indicated in the chart showing private domestic nonfinancial corporate borrowing. That has a lot to do with our very sluggish productivity over the last 10 years or so because corporate borrowing has been preempted by the Government's participation in the credit market.

Then, we can see the ultimate final situation that we have been facing. The Fed has been under pressure to accommodate these borrowing demands. Every time the borrowing demands start rising during the beginning stages of a recovery, the Fed, Congress, and the administration are concerned that the recovery is going to be checked off before it has a chance to get started.

Throughout the years, these deficits have forced the Fed to monetize a good portion of the increases in financing. That has pumped up the growth rate of M_1 and other monetary aggregates.

This is the 15-year history the bond investors have seen. Investors don't know if that is going to be repeated.

I am convinced that the Fed is committed not to cave in, and I think the slight accommodation we have seen over the last month it is not caving in, and I think Paul Volcker is going to stick to his guns.

That does preclude problems next year, though, because we do have an expansionary fiscal policy. I see the economy a little better off next year, starting in the second quarter—not robust and certainly not a 4- or 5-percent real growth in GNP—but picking up in the 2- or 3-percent area in the second part of the year.

That is going to part produce an increase in private credit demands, and Treasury borrowing demands are still going to be heavy. Treasury borrowing is going to be especially heavy in the first quarter of 1982. That will ease off in the second quarter because of seasonal considerations. But still, in terms of note and bond financing, it is going to run around $12 to $13 billion. So I can see difficulties lying ahead.

Let me just backtrack and try to give you a longer term grassroots program. This is in the mind of investors, and I don't think investors are yet ready to come back to the market, and until they do, there is no way we can see any sustainable declines in long-term rates. Let me just be a little realistic about what the markets really are right now.

The bond market, as we know it, is not what the bond market was 2 years ago or 3 years ago. If it was, there is no way you could justify long-term rates where they are now.

The problem is investor perceptions. If you look at long-term yields, there is no reason if investors felt, if they believed, that the deficit could be lower next year than this year, lower the year after that and lower the year after that, and maybe balanced in 1984, but certainly not going the other way, they would be buying up every bond in sight. There would be such a plunge in long-term yields, it would amaze people. It would come so fast that it would alleviate much of our problems. It would take large corporations out of the short end of the market. It would allow them to restructure balance sheets which now are so lopsided short-term versus total borrowings, that at some point restructuring the balance sheets has to occur or else not only the small business, but the large corporate nonfinancial sector, is going to be in very serious trouble.

The key is one thing. It is perceptions on the part of the investors. Right now, the market is dominated by a handful of dealers. They are capable of taking long-term yields up 150 basis points in 2 days if they want to. They can do that because there are no investors. Let me just go into a matter.

We had recorded high long-term yields of 14¼ percent prior to the Treasury's May quarterly financing. Then came the pre-August quarterly financing period in July and yields got even higher. Over the past couple of months, they have risen to 15¼ percent. It is very easy for this small market to drive up yields because, in reality, yield increases represent the passing of dealer positions from hand to hand.

Now, that is not a market as we know it.

On the other hand, if something were to occur to bring about a change in perceptions and investors came in buying, this handful of dealers could not run rates up as easily as they can now.

Now, what about perceptions?

Senator D'Amato. If I might just ask you this: What about suggestions to how you would change these perceptions? You lead one to believe that there is that act to change the perceptions, and you believe that the street, the market, would respond to that.

Could you give us, if I might, some of those signals that would be necessary to change the perception as it now exists?

Mr. **Maude.** There are two key signals: One is on the monetary side; the other is on the fiscal side.

The signal on the monetary side has come through loud and clear. I don't think that the investment community really doubts the resolve of the Fed, but there are serious questions on the fiscal side.

If you want to compare the Carter and the Reagan budgets for example, expenditures are something around $510 billion lower under the Reagan budget than under the Carter budget, which is constructive.

A lot of those cuts, though, are unspecified as of yet. The problem is the other side. If you look at the Reagan versus the Carter budget, revenues are $760 billion less under the Reagan budget than it was under the Carter budget.

I think in some way it can be shown, and we have heard suggestions to that this morning, that that gap could be narrowed, and if the $350 billion less in expenditures are more clearly defined and specified instead of generalized as something that we can forget when the economic situation becomes weak and we start worrying about unemployment, and if they are further specified and the path further committed, then perceptions would change.

I don't think it is a good idea to scrap the tax cut or even start paring it. It would be just another shift in policy. I do think the ideal solution is to tie the tax cuts to the budget cuts, which I think has always been a good idea.

I think there is one tactic involved here which I favor. I feel very strongly that had taxes not been cut, we certainly wouldn't have seen the magnitude of spending cuts that we did. On the other hand, a gun is being held to Congress for fiscal 1982, 1983, and 1984. They know those tax cuts are coming. They have to do something on the other side. It is good to keep that gun loaded. We need that gun or else there would be no expenditure cuts.

Otherwise, I firmly believe the Government would just find ways of spending the money. But what you also need is further expenditure cuts. We could have deficits, if those expenditure cuts don't come through, in excess of $100 billion.

Keep in mind, come 1985, and thereafter, the tax rates will be immune to inflation. Yet, the expenditures will not be.

Senator **Weicker.** Well, if I may just stop there. Anybody who wants to run the risk of allowing a bunch of politicians do that just defies political history.

Now, you know economics. But I know politics. And I have always belonged in the school that ties tax cuts and spending cuts.

I think tax cuts ought to be earned. I think anybody that wants to run the risk of flying in face of what has been history deserves what they get. I am going to tell you right now I have never been for this tax cut for that very reason, and the only way it becomes a gun is if you really believe that the balanced budget is all important in the congressional mind.

If in any way that starts to drift, then what you have done is just to hugely widen the deficit, and I think that is exactly what is going to happen.

Senator **Nunn**. It is more like a gun being held at the head of economy, saying if you don't improve the budget, I am going to shoot, and bang, the economy is dead.

Mr. **Maude**. Congress loves to cut taxes and loves to increase spending, and that is what the bond markets are telling you, exactly what you two have said.

Senator **Nunn**. Let me just ask one question too, and then we can go ahead.

You have just described indexing. In the beginning of 1985, we have indexed the taxes, but we have not done anything to change the indexing, the spending, so what you have is that revenue is no longer tied to the increase in inflation but expenditures are.

That is almost surely a prescription for bankruptcy; isn't it?

Mr. **Maude**. It is a prescription for deficits that will stagger the imagination unless you bring inflation down to zero, and I don't think even the most optimistic would say that.

So I would say just follow through. We have got the monetary side commitment. We need a commitment on the fiscal side to find some way of narrowing, whether it be tying future tax cuts to further expenditure cuts or charge further into the sacred cows of entitlement programs and defense spending, or a combination of those.

Until there is some assurances that at least some semblance of balance is going to be seen by the middle of the decade, I don't think investors are going to be turned around because at some point when they see the fiscal side caving in, even though they are firmly convinced now on the monetary side, they start looking for pressure back on the monetary side.

I think not getting into personalities. I don't think public statements criticizing the Fed's tough stand are conducive at all toward improving perceptions in the investment community, and I do think Congress and the administration should commend restrictive anti-inflation monetary policy.

There is no easy solution out of the situation, and the longer rates stay up, the more difficult the problem is going to be. I will give you one very simple example, and this is what they have been experiencing in the United Kingdom.

Right now if you just look at short-term large business demands which have been exploding over the past several months, it is not too surprising. Commercial paper outstanding are running around $165 billion. Commercial industrial loans, short-term loans, around $350 billion. Add those two together. Impute a very modest 16 percent rate of interest. Do you know you come up with $5 to $6 billion per month borrowing requirements not to finance activity, not to finance inventories, but to payoff the interest on the loans?

The sustained high level of interest rates is eating into cash flow, not only destroying the small businessman, but the large corporations, and this is at catch 22 situation with respect to interest rates.

The interest component is creeping into money supply measures and is causing the Fed to stay restrictive. The Fed is staying restrictive because of a rapid growth in MT business growing rapidly because interest rates are so high.

One other irony in this interest rate situation is that everyone is crying about the high interest rates, yet, if you look at personal income changes over the first 7 months of this year, 43 percent in the increase in personal income came from wages and salaries. The second largest contributor to personal income was not social security or transfer expenditures. It was interest income that contributed 24 percent to personal income, so there is a buoyant impact. It is hurting some. It is helping others, but it is feeding into the system, and they have got to be brought down, and there is no way they could be brought down artificially.

There could be a directive issued to Paul Volcker tomorrow saying "Get those rates down." He could pump. There would be a short rally. Within a week, institutional investors would dump everything they have with the maturity of the past 7 months.

There is no simple way. The only way of doing it is to pursue the right monetary and fiscal policies. Right monetary policies are there. I don't think the right fiscal policies are there.

Senator WEICKER. Mr. Maude, I thank you very much for your testimony again. It has been valuable to the small business community.

Senator NUNN. Mr. Chairman, I have another question.

Mr. Maude, you mentioned the forecast by Merrill Lynch on the bull bond market back in the spring of 1981.

Mr. MAUDE. Summer of 1981.

Senator NUNN. What caused that projection to be made at that time, and what assumptions were made at that time that have not transpired?

Obviously, if you could back up to that period of time, you would not make the same prediction based on what I hear you saying today.

Mr. MAUDE. I wouldn't veer away from it completely. There were three key things that caused us to form that judgment taking a longer term view.

One, and the key one, was the monetary side. We felt that after the mistakes of last year in the spring and in the fall, the Fed had learned a lesson.

Since November of last year, the Fed has shown a determined and decidedly restrictive monetary policy.

There have been opportunities for them to veer from the course. They have not chosen to do so.

The other was intent of fiscal policy to bring down the share of Government participation in the economy in terms of bringing Government spending down to less than 20 percent of GNP, and which in turn would bring in terms of participation in the credit markets.

The third was we thought we were in a period with an administration that was not going to veer or bend at the first signs of pain and try to put a band-aid on it at the cost of causing substantially more pain 2 or 3 years down the road.

We thought their attitudes with the S. & L.'s was a pretty good example of that, although there have been despite bailouts through Ginny Mae, through the Federal Reserve discount window, et cetera. But not the kind of bailouts that we would have expected from other administrations.

A lot of those things are still intact. I still have faith something is going to be done to gain credibility on the part of the administration. I question whether they are going to continue to be effective enough to get that through Congress, especially in an election year.

Now, the first half of next year is going to be critical, and I think Congress and the administration is going to be watched very closely and the Fed by the financial market.

That is the critical period in terms of having really made a genuine turn or just trying something new and then going back on the same old course.

Senator NUNN. One other question, Mr. Chairman.

If you assume what Dr. Yardeni assumed—that is that Congress was going to do virtually nothing more than is already in place on both the tax side and the spending side—under that assumption, what do you see for the economy?

Mr. MAUDE. On a fundamental basis, I don't think $13 billion makes that much difference. I don't think it is going to have that much of an impact on the flow of funds in the credit markets.

I don't think it is important in those terms whether we have a deficit in fiscal 1982 of $60, $70, or $80 billion, but psychologically, it is important, and what we are saying here is that psychology can determine interest rates, which can severely impact the economy.

If nothing is done, I can see long-term yields going right back up to record high some time next year with no problem at all.

Senator D'AMATO. Mr. Chairman, if I may.

Are you saying cuts as distinguished from revenue-producing measures should be used to decrease the deficit?

Mr. MAUDE. No; I think any combination. It could be anything to show that you are capable of narrowing the gap.

Senator WEICKER. Mr. Maude, thank you very much.

The committee's hearing is adjourned.

[Whereupon the committee adjourned at 12:40 p.m.]

[The prepared statement of Mr. Maude follows:]

Merrill Lynch

Statement by

DONALD E. MAUDE

Chief Financial Economist
Chairman Interest Rate Policy Committee

Before the Senate Committee on Small Business

United States Senate

New York City, N.Y.

October 14, 1981

Mr. Chairman:

It is indeed my pleasure to have this opportunity to testify before you and members of your Committee on "The Problem of High Interest Rates: Causes, Consequences and Outlook." I am sure many of the things that I will say have already been echoed here today by my colleagues and in the hearings you conducted recently in Washington, DC. However, far from feeling that this is an unproductive, time-consuming exercise on your part in hearing a redundant theme, I fully endorse and commend your eagerness to gain views from the trenches of Wall Street and Main Street. All too often these days legislators in Washington have devoted too much of their time defending policies rather than attempting to find out how such policies can be improved in the best interests of all "Streets" in the nation. As per your request, I will keep my comments quite brief in order to allow sufficient time for questions and answers.

In this regard, before touching on some of the causes of today's historically high interest rates and the outlook for the period ahead, I would like to briefly outline some of the consequences for small business from the current high interest rate environment. To do so, I have taken some key statistics that have been recently made available to me by the National Small Business Association.

Consequences . . .

From mid-1980 to mid-1981, court-filed business bankruptcies increased 30.1%--the second largest year-to-year rise of the past 20 years, only being surpassed by the 45.2% increase between 1974 and 1975. Further reinforcing the seriousness of the situation are statistics released by Dunn & Bradstreet for the period January 1 through September 3 of this year. Such statistics indicate that business bankruptcies jumped by 41.8% compared with the same 35-week period in 1980. Not surprisingly, the major jump came in the construction industry which is reeling over the stranglehold of high interest rates. Somewhat more surprisingly, however, has been an equally sharp jump in bankruptcies in the retailing and services sectors of the economy. These statistics, it should be kept in mind, do not reflect what are known as "walkaways" in which businesses have just chosen to close their doors and terminate the business. Many leading experts feel the number of such walkaways is substantial indeed.

These business difficulties, it should be kept in mind, are not just confined to small business. Indeed, they have a pervasive impact on overall employment in the economy. By way of example, the 15 million small firms in the United States which file tax returns account for 55% of existing employment and approximately 80% of all new jobs. Quite obviously, small business difficulties have a significant impact on the unemployment rate in the nation. This, in turn, has implications for the Treasury's coffers as well since each 1% increase in the unemployment rate adds anywhere from $25 billion to $29 billion to the deficit in the form of foregone revenues received and increased benefits paid.

While it would indeed be quite simplistic to attribute the previously outlined difficulties of small business strictly to interest rates, there has in fact been a close correlation between interest rate movements and small business failures. Indeed as the attached graph shows vividly, the prime rate and business failures over the 1978-1981 period have moved almost in lock step.

Causes . . .

An analysis of the causes of today's high interest rate environment cannot be covered in ten minutes, ten hours or even ten days since the process has been so complex and the difficulties so ingrained. However, one does not have to look far to find some of the critical roots leading to the present situation. So, as not to belabor some of these causes at this session, I have included in today's testimony a copy of my testimony before the Senate Budget Committee back in January of this year. I will point out some of the salient features of that text.

As the table on Page 2 shows, in the first half of the 1960's, for example, Federal Government expenditures were running at an annual rate of 4.3%--representing 19.0% of GNP. This rate of increase moved up to an annual rate of 14.8% during the height of Vietnam and Great Society spending during the 1966 to 1968 period. It then receded to a 7.1% annual rate from 1969 to 1974--or 20.4% of GNP. From 1975 to 1980, however, its rate of growth accelerated sharply to 13.7%--or over 22% of GNP.

Not coincidentally, as spending outpaced revenues in all but three of the last twenty years and resulting deficits had to be financed, Federal Government borrowing as a percent of GNP and total credit market borrowings have grown rapidly--as is shown in Table II on Page 5. The chart on Page 6 shows how this borrowing has crowded out the private nonfinancial sector of the market and the charts on Pages 7 and 8 show how these deficits impacted monetary policy, money supply growth and interest rates.

With the knowledge of this historic backdrop, investors now know that the largest tax cuts in history are now law and that huge yet specified expenditure cuts are going to be difficult to enact. The result, will be swelling budgetary deficits. If the Fed fails to monetize such deficits, interest rates will remain exceedingly high. If the Fed does attempt to alleviate pressure in the credit markets by monetization, excessive money supply growth and accelerating inflation will be the ultimate outcome. In effect, the Fed is in a Catch-22 situation with respect to interest rates.

Outlook . . .

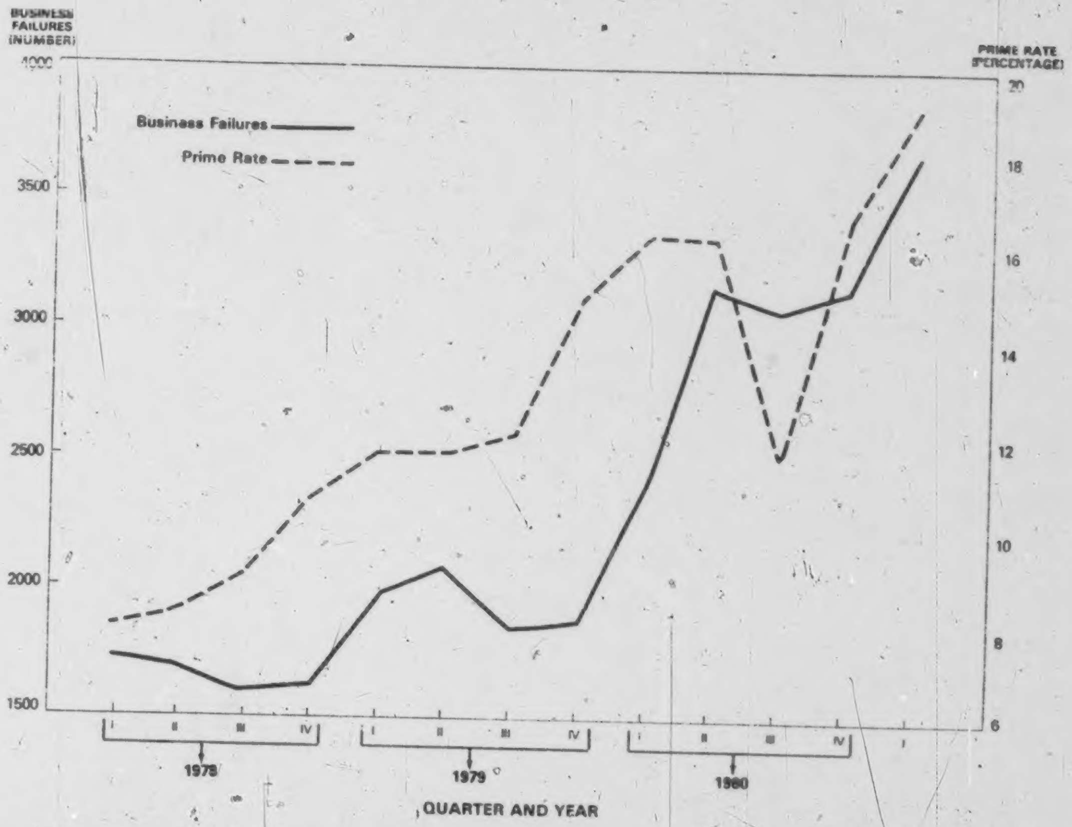
A detailed outlook for the economy and interest rates for the months ahead is outlined on Pages 1 through 4 of the CREDIT MARKET DIGEST included with the other material. As can be seen by the Interest Rate Forecast Table, rates could edge lower, on balance, between now and the end of the year though the path pursued by rates will be anything but even. The table also shows a steady uptrend in rates over the first half of next year and then some slight declines over the second half of the year. I must caution, however, that the Forecast Table in no way picks up the high degree of volatility that we will see during intra-quarter periods. In effect, what we have to look forward to over the next year or even more is the continued clash between the stimulative fiscal policy and the highly restrictive monetary policy and a convergence of accelerated private and high Government credit demands. In short, the roller-coaster course that interest rates have pursued over the past two years or so will continue as far as one can see. Additionally, high levels of interest rates will be a major feature of this environment.

Appropriate Policy Response . . .

About the only way to genuinely and sustainably bring down interest rates is to develop a better balance between fiscal and monetary policy. In no way is the solution to be found in encouraging the Fed to attempt to artificially bring down interest rates at the cost of excessive money supply growth.

Indeed, given the present rational expectations of the marketplace, it is unlikely that the Fed even has the ability to temporarily engineer a decline in intermediate and long-term rates. The concerns of the markets are excessive budgetary deficits and the attendant crowding-out impact on the other sectors. These concerns will not go away until more concrete evidence becomes visible that either the tax cuts will be pared and/or further expenditure cuts than previously announced will be enacted.

BUSINESS FAILURES AND PRIME RATE



SOURCES: FEDERAL RESERVE BULLETIN, DUN & BRADSTREET

INTEREST RATES AND BUSINESS CREDIT NEEDS

MONDAY, OCTOBER 19, 1981

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Memphis, Tenn.

The committee met at 10 a.m., at 100 North Main Building, Memphis, Tenn., Hon. James R. Sasser, acting chairman, presiding.

Present: Senator Sasser.

Also present: Robert J. Dotchin, staff director; James J. O'Connell, economist; and Gregg Schuder, Office of Senator Sasser.

STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator SASSER. First let me say that I want to thank all of you for attending our hearing today on the problems created by high interest rates.

I am especially grateful to those of you who will serve as witnesses today. I know that preparation takes time and effort and energy and I do appreciate your help in spelling out the impact of high interest rates in the Memphis area.

I want to take just a moment and express my particular appreciation to the Memphis Chamber of Commerce for joining with us today and sponsoring these hearings. I've said this in Washington, and I've said it in other areas of the State of Tennessee, but Memphis is fortunate, I think, in having one of the most aggressive and forward-looking chambers in this country, and certainly in our State. I want to thank the president, Tom Turner, of the Memphis Chamber, and Tiffany Bingham, the executive vice president of the chamber, and also Edwin Elam of the chamber of commerce for their splendid cooperation and for their great interest in seeing that this very serious problem that we have today is given a full hearing.

Also, we had hoped today, and planned today, to have my distinguished colleague from Arkansas, Senator David Pryor, to join us. Senator Pryor has a profound interest in the impact of high interest rates in our area, and certainly among his constituents in Arkansas. Unfortunately, due to circumstances beyond his control, he will not be able to join us. I have a statement from Senator Pryor which I will insert in the record completely, but I would like to read just the first part of it to give an explanation for his absence.

It says, "I would like for all of you to know," this is Senator Pryor speaking, "how sorry I am not to be with you, but my son Scott has suffered a football injury and is in the hospital in Washington. His doctors have recommended that I stay with him, and I feel that my responsibility is here with my family in Washington." I'm sure you all understand that and I wish Senator Pryor and his son Scott all the luck in the world, and a speedy recovery.

Well, to address the question before us today, I think we all know generally the results of the high interest rate policy which is being pursued by the Federal Reserve. This high interest rate policy, I think, is very destructive to our competitive free enterprise system. Today, we want to lay out in some detail, the economic injuries which this misguided policy has inflicted on Memphis, on west Tennessee, on Arkansas, and indeed, on the entire Mid-South. I might say in passing that we have now reached a 20-year high of business failures in this country. If business failures continue for the rest of the year 1981 as they have for the first part of the year 1981, we will have experienced more bankruptcies and more business failures in this country than any time since the great Depression year of 1933.

Now, we have witnessed in this country something also that's been unprecedented since the Great Depression, and that is a 3-year period in which we have had no increase in gross national product of this country, but indeed, a net decrease in our productive capacity. I know there have been quarters in which we have increased our GNP and increased our productive capacity, but taking together, adding them all together over 3 years, we have had a net decrease in our productive capacity that has not happened since the years of the Great Depression, and I think it can be attributed, in large part, to the erroneous high interest rate policy that is being pursued by the Federal Reserve Board.

Let me say that this is an official hearing of the Senate Small Business Committee here today. These hearings will be transcribed and placed in printed form and made available for distribution to the public. The hearings will also, I think, be helpful to other Senators from other States and other chambers of commerce in other parts of the country who might wish to hold similar inquiries.

I might just say briefly that the National Small Business Association and the National Federation of Independent Business, who represent hundreds of thousands of small business people, consider interest rates as the paramount business problem in our country today.

In my travels, and in meeting with business people, farmers, and just consumers, all across the State of Tennessee, I find that the devastating impact of excessively high interest rates is a major issue—perhaps the major issue—with our people. And well it should be, because these high interest rates cause business failures. Entire industries are in a depressed condition. Farmers are suffering. Consumers are suffering, because they feel they can't afford to make the purchases they need because of the excessive rates. We are experiencing in the State of Tennessee, for the first time in my life, an unemployment rate of 8 percent, which is in excess of the national unemployment rate of 7.2 percent.

Business failures are up 41 percent of this year over last year.

In Tennessee, applications for bankruptcy have increased by 39 percent this year over last year.

Farm production costs are skyrocketing. It has been estimated that as many as 25,000 farmers who were in business in 1980 will be out of business by the end of the year 1981.

More than 2,000 automobile dealerships have failed in the last year. That is approximately 10 percent of the entire autodealer network here in the United States. And I might say that it does no good for Congress to try to advance funding, or guarantee loans for our ailing auto industry, particularly in the case of Chrysler Corp., when the Chrysler dealer down the street is out of business. And there's nobody in the small communities or small towns across this country to sell Chrysler vehicles, even if they should become, and I think all of them are becoming, and are now, a very cost-competitive automobile.

The long-term bond market has been severely retarded and the stock market is very unsteady. And these are all the results of a whiplash effect of high interest rates.

So we want to focus attention on this problem here today. I've been trying to do this now for almost 3 years in the U.S. Senate. I introduced a resolution in January of this year, on the first day that the Senate came back into session, calling on the Federal Reserve Board to roll back the interest rates, calling on the Joint Economic Committee of the Congress to make a study of the Federal Reserve System itself, and recommend structural changes that would make the Federal Reserve Board more responsive to the overall needs of the economy. Well, now, finally it seems that we're getting some movement. Secretary of the Treasury, Mr. Regan, has called on the Federal Reserve Board to lower its rates. So we're making some progress.

[The prepared statement of Senator Pryor follows:]

STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM THE STATE OF ARKANSAS

First let me thank everyone for offering testimony and cooperation in many forms so that today's forum could take place. I would like all of you to know how sorry I am not to be with you, but my son Scott has suffered a football injury and is in the hospital in Washington. His doctors have recommended that I stay with him, and I feel that my responsibility is here at home.

One of the purposes of Congressional hearings, whether in Washington or back home, is simply to identify the problems we face. Giving them a name and a firm identification is often the first step in finding solutions.

Everyone knows, for instance, that businesses would prefer borrowing funds at lower rates, and we have all seen the devastating effects of high interest rates on such industries as homebuilding and automobile manufacturing. But now, after many months of sky-high interest rates, we are beginning to notice other effects:

How an entire age group has been squeezed out of the housing market;

How this same group has trouble borrowing money to start a business;

How the age group nearing retirement has begun to adjust its own retirement and investment plans to divert some of its earnings to sons and daughters;

How a number of businesses not considered particularly interest-sensitive are also suffering after long exposure to the high rates; and

How consumers are forced to absorb the cost of borrowing and live without many of the goods and services they need.

One impressive indication of the effects of high interest rates is the jump in bankruptcies. Since last year they are up by more than 40 percent. It appears, in addition, that nationwide business failures next year will reach a 20-year high. And 90 percent of these businesses, according to Dun and Bradstreet, are businesses with liabilities of less than one million dollars. In other words, the small and family-owned businesses of this country are the ones bearing the brunt of the perilous economic times.

Every member of Congress has met many of the people reflected in these statistics. All of us know them. Many of us are them. For the most part, they're people who have been forced to defer or abandon their businesses and personal goals. Certainly there is no lack of awareness of the problem in Washington.

But I think it would be helpful to find out a little more about the circumstances of these bankruptcies. We need to hear firsthand the strategies businessmen might use to hang on until the interest rates drop. We especially need to know a possible role for the government to play in warding off further attrition among small businesses.

I have yet another hope for today's hearing. I hope it will lead us closer to finding a solution to the problems we all face under current conditions. While there is much to learn about interest rate fluctuations, there is a wider canvas than this. I am convinced that in the long run the only way to reduce rates and keep them low is to cut government spending, reduce the deficit, and lower the federal presence in the credit markets.

There is only so much money to go around. When big business, small business (including agriculture), individuals, and government at all levels compete for available funds, there is little doubt who will be squeezed out. It is inevitably the single voice that gets out-shouted.

All of us know that it will take some time before the effects of reduced spending are visible. In addition, a number of approaches are now being considered in the Congress, particularly in the area of housing. Here are some of them:

Tax-free savings for first-time homebuyers;

Tax credits for the purchase of inventory homes;

Authority to invest pension funds in home mortgages; and

A limited mortgage bond program—which I know has particular appeal to Senator Sasser.

I would welcome any comments on these approaches, or on any others that might be helpful in this or other fields.

Another matter I hope our economists will address is an interpretation of the recent drop in the prime rate. I believe it would be a mistake to read too much good news into these new figures. They may simply reflect a new recession, or they may be a temporary, tantalizing drop before rates go up higher than ever. Certainly the Federal Reserve Board has indicated that it intends to hold fast to its course in restricting money growth, so we can look for no relief from that quarter.

I look forward to reviewing the testimony of the fine witnesses scheduled to appear today, and I hope that we will all come away with a better understanding of the frightening and dangerous conditions we operate under these days.

Senator SASSER. I look forward today to hearing our witnesses, and we'll lead off with a statement from Mr. Tiffany Bingham, the executive vice president of the Memphis Chamber of Commerce. I want to welcome you, Mr. Bingham, and say we look forward to your statement today.

STATEMENT OF C. TIFFANY BINGHAM, EXECUTIVE VICE PRESIDENT, MEMPHIS AREA CHAMBER OF COMMERCE

Mr. BINGHAM. Thank you, Senator. We're sorry that your good friend and colleague, Senator Pryor, is not here, but we do understand. It is with great pleasure that I welcome you on behalf of the chamber of commerce and the Memphis small business community. This is especially true because of the nature of the concerns which prompt you to visit our community at this time.

Small business is critical to the growth and prosperity of Memphis and the Nation as a whole. Almost all businesses start out as small businesses, and if successful, go on to become big business. Small business is the home of the entrepreneur, that creative risktaker who has been responsible for making America the leading economic power in the world for most of this century. And, despite the presence in our society of huge corporations employing hundreds of thousands of individuals, the growth of small business is becoming increasingly more important in Memphis.

Just last week, we had the pleasure of hearing from Dr. David Birch, of the Massachusetts Institute of Technology, the feature speaker at a townhall meeting sponsored by the Memphis Jobs Conference. Dr.

Birch and his colleagues have created a computerized data base covering the majority of all the businesses located in the United States.

In analyzing these data, Dr. Birch has reached some startling conclusions. Over the past 10 years, 60 percent of the net jobs growth in the United States has come from firms employing 20 or fewer individuals, and 80 percent of the jobs growth in the United States has come from firms employing 100 or fewer individuals. If anyone ever needed evidence that small business in America is alive and well, Dr. Birch's findings should provide reassurance. As for Memphis, the statistics are even more revealing. We now rank in the top 15 percent of all communities nationally in terms of creation of small businesses in the service sector and related fields. Without our active and growing small business sector, community problems of unemployment and racial friction could be much worse than they now are.

Yet, despite these reasons for optimism, there remain dark clouds on the horizon for small business in America in general, and in Memphis in particular. First and foremost, small business finds itself in the position of not having adequate capital to aggressively and effectively pursue the many innovative ideas and opportunities placed before it every day. And the capital which is available is so expensive that the small businessman finds it difficult to see the benefits in taking entrepreneurial risks, knowing that in the end, most, if not all of his profits will go to pay the piper in the form of high interest rates. The reasons for this predicament are complex, but the single most important cause is clearly the tremendous Federal deficits, which year after year drain resources from the private business economy, driving up interest rates and driving out the small businessman. Now we find that the small businessman is about to be hit once again, this time from behind. The very Federal Government whose activities have caused interest rates to be driven up and credit to be made scarce, now proposes to go one step further and deny the small businessman those Government small business programs which have provided an exception to the otherwise bleak financial picture.

Proposals have been made to do away with SBA business loans, limit SBA guarantees, abolish industrial revenue bonds, and otherwise deny the small businessman those few opportunities which he now has to obtain access to affordable capital in competition with the giants of American industry.

Throughout the afternoon, you will be hearing from small businessmen, government officials, and others knowledgeable about the economic plight of small business. We ask you, Senator, that you carefully consider what you hear, and that upon your return to Washington, you act as our spokesman, not only to tell the story of a small business, but to advocate programs, policies, and activities which will assist the small businessman in building a better future for our country and our city.

To accomplish this, we suggest that the Federal Government adopt the promotion of small business growth as a top priority national goal. This goal should then be implemented by adoption of a formal review procedure to analyze each significant piece of Federal legislation and each Federal program to determine their impact on small business. This must then be backed up to your commitment, and that of the Congress as a whole, so that programs and policies good for small business will be adopted and encouraged, and those bad for small business will be defeated.

Thank you very much for coming to Memphis and being with us today.

Senator SASSER. Thank you, Mr. Bingham, for that thought-provoking statement. And once again, I want to express my appreciation to you and the Memphis chamber for your cooperation, and also my appreciation to the Memphis chamber for its profound interest in small business and its efforts to develop small business in this community, and to represent small business interests in the governmental area. Thank you.

Mr. BINGHAM. Thank you, Senator.

Senator SASSER. Next, we have a panel. Dr. Kurt Flexner, professor and former chairman of the Department of Economics at Memphis State University—would you come forward, Dr. Flexner?

Dr. Susan Bies, economist at First Tennessee Bank of Memphis; and Mr. Terry Britt, vice president at Sparks Commodities in Memphis, former vice president and branch manager of the Memphis branch of the Federal Reserve Bank of St. Louis.

This panel will occupy itself with an economic analysis of our present situation. I hope that will give us suggestions as to where to go from here.

Dr. Flexner, we will start with you. And let me say to you and your colleagues, welcome, and we look forward to your statements or observations today.

STATEMENT OF DR. KURT FLEXNER, PROFESSOR, DEPARTMENT OF ECONOMICS, MEMPHIS STATE UNIVERSITY

Dr. FLEXNER. Senator Sasser, I am pleased to have the opportunity to testify at this hearing, because I believe that our present economic policies will create problems which will become serious obstacles to genuine economic recovery.

The administration is putting all its hopes on economic policies that would not even be effective if our economic problems were what the President and his advisers imagine them to be, but they are not. Their policies are based on the assumption that productivity is low and prices are high because Federal spending and Federal taxes have increased too rapidly, and that the Federal debt has grown too fast. These factors, in the view of the administration, are responsible for the inflation and the decline in private investment.

The President's remedy for inflation, low productivity and inadequate private investment is what his advisers have labeled "supply side economics". This is based on the belief that investment and productivity will recover if Federal spending and Federal taxes are reduced. It also assumes that inflation can be controlled by a balanced budget which will keep the money supply from growing too fast. The Federal Reserve believes that since the budget is not yet balanced, a restrictive monetary policy and high interest rates must be adhered to until the budget can be balanced.

The causes of economic problems are complex and they cannot be discovered with ideological biases. Until they are correctly perceived, it is highly unlikely that effective remedies will be applied. The danger of applying the wrong policies to economic illnesses is no less real than the danger of the wrong prescription when a person is ill.

Let us look at the facts. Federal spending, as a percentage of the GNP, was about 19 percent in 1960, and about 21 percent in 1980. Federal taxes between 1960 and 1980 have fluctuated somewhat around 20 percent of the GNP. In 1980, Federal employment was 3.2 percent of the total labor force. That is somewhat less than it was in 1960. Federal purchases of goods and services, as a percentage of the GNP, were also lower in 1980 than in 1960. Only transfer payments increased during this period, from 5 percent of the GNP to 9 percent of the GNP, but the bulk of that increase represents Federal tax dollars going to the States and local communities. The increase in total Federal spending from 19 to 21 percent of the GNP was certainly not enough to cause our economic problems.

The national debt has grown from $20 billion at the end of Hoover's Presidency to $1,000 billion today. Its size, however, has to be judged by its relation to the GNP. In 1932, the ratio was 40 percent of a $50 billion GNP. In 1941, after 8 years of the New Deal, as a result of increases in the GNP, the ratio of the national debt had dropped to 35 percent from 40 percent in Hoover's time. After World War II, the debt was considerably larger than the GNP, as a result of the war. It dropped to 60 percent of the GNP in 1960, and today the $1,000 billion debt is one-third of the $3,000 billion GNP, a lower ratio than it was in President Hoover's day.

The size of the debt is not its problem today. The problem is the outrageously high interest rates which make the interest payment on every dollar of the debt about eight times as large as it was in 1932, and four times as large as it was during the Kennedy administration.

The timing and use of deficits which make up the debt is very important. Even if the debt were zero today, we should not pursue policies designed to create unemployment and large deficits at the same time. That makes no sense at all.

The trouble with the administration's policies is that they are based on doctrines rather than facts. This not only prevents us from solving our problems, but creates new problems which aggravate the old ones.

It is highly unlikely that present policies which are responsible for the current contraction in output will result in increased productivity. It is more likely that they will prove an obstacle to it. Increased productivity in the American economy is in no small measure the result of innovations introduced by new firms, generally small firms. These firms are the pioneers on the frontier of the technological revolution. Frequently the successful ones are absorbed by existing large corporations via the conglomerate route. The unsuccessful ones disappear.

Although the American economy is highly concentrated, judged by the economic significance of the Fortune 500 firms, small new firms with a high technology orientation play a vital role in economic progress. Many small firms, of course, do not play this role since they are not high technology oriented. Their role is still significant, however, because they give people a choice between work and welfare.

The Federal Express Corp. is an excellent example of an originally small firm with a high technology orientation. Firms like that add a new dimension to economic progress.

Such technology oriented firms require capital to get started, whether they are engaged in manufacturing or in the service industries. Federal Express, a service industry, has a capital base of $35,000 for each of its 8,000 employees.

The administration's program, with its excessive dependence on monetary policy, which has produced discouragingly high interest rates, is badly damaging the innovative processes of our economy. New high productivity businesses which operate on the frontier of economic progress cannot get started, or if they do, cash flow problems slow them up or destroy them. As a result, instead of raising productivity, our current policies are likely to stifle it.

Not only the potentially high productivity small firms will be affected. In Memphis, most small firms fall in the lower productivity category, which pay relatively low wages. These firms, however, provide many of the jobs available in Memphis, and without them, unemployment would soar. Such firms require credit to operate, and our current monetary policy with its exorbitant interest rates is threatening the existence of those which have not yet succumbed to bankruptcy. The future of these firms is further endangered by the effects of a contracting economy.

Low productivity, inflation and inadequate private investment are serious problems, but they were not caused by excessive increases in Federal spending and taxation, nor by a rapidly growing public debt, as the administration claims. Productivity is low, partly because the innovative quality of our formerly progressive economy is not visible in most of the giant firms in our basic industries. In recent decades, they were able to survive without much modernization. Now faced by world competition, their obsolescence has created serious problems. Nothing the administration is now doing will revive them.

Partly, productivity is low because the smaller and newer firms on the frontier of new technology are handicapped by the adoption of monetary policies which have their greatest impact on small firms. These firms are also handicapped by a financial system which does not lend itself very well to the requirements of small or new firms.

Productivity is also low as a result of an educational system which leaves many of our young people unprepared for a rapidly changing world. The combination of an expensive but inadequate educational system and policies which cause economic contraction instead of job opportunities breed people who become a burden to themselves and their communities.

The administration's belief that inflation is caused by Federal deficits and the effect of these on the money supply reflects an oversimplified conception of our economy. We would get a much better glimpse of the economy if we looked beyond the Federal deficits and the growth in the money supply, and concentrated our efforts on the real causes of inflation instead of confusing the causes with the symptoms.

Inflation has a variety of causes. Low productivity is one, because in industries with strong unions, wages frequently increase more than productivity, which is inflationary even if the wage increase is less than the inflation rate. In nonunion industries, low productivity generally leads to low wages, frequently making subsidies a necessary part of existence. Subsidies, or transfer payments, if they continue to grow, become inflationary. The solution is not to eliminate, or even to reduce, legitimate transfer payments, because that leads to political instability. The solution lies in positive action designed to increase productivity. High interest rates and economic contraction will not accomplish that.

Administered prices are another cause of inflation which our present policies won't affect, unless they lead to a severe depression. Unemployment and underemployment can contribute to inflation by reducing supply in relation to demand. This is especially true when transfer payments are regarded as a desirable alternative to programs which create economic opportunity.

Some of the causes of inflation are more sophisticated. Environmental protection costs are treated as a rise in prices instead of what they really are—a new product vital to the interest of the consumer. Suppose we add $1,000 gadget to a car in order to protect the environment from pollution. As it now stands, this raises the price of the car by a $1,000. Actually, the gadgets are another commodity which, if they were attached to our noses, would not increase the price of the car at all. The kind of monetary policy we now practice cannot deal effectively with such problems.

The rise in housing costs, as it is now treated in the Consumer Price Index, exaggerates the rate of inflation. Only about 10 percent of the people who own homes purchase new homes during a given year. The rest live in homes that are not affected by increased prices or interest rates.

The causes of economic problems are complex, and we must not delude ourselves into believing that all we have to do is balance the budget and control the money supply and the problems will go away. Real supply side economics would undoubtedly help. That is entirely different from what is being done now.

It includes adequate investment in human capital, which should involve a close new look at our systems of education and training, which leaves presently much to be desired. Real supply side economics involves the creation of productive jobs as an alternative to transfer payments. This requires a new look at research and development expenditures. Included should be the development of a financial system geared specifically to the financing of high technology new businesses.

The large firms and banks in the private sector of a community such as Memphis may consider pooling perhaps 5 percent of capital and surplus into a business development fund to be used for financing new businesses which fit into the growth pattern of the community. The Federal Government could participate in such an arrangement through guarantees and tax encouragements. Perhaps the banking system should reconsider its policies in regard to new businesses. Before 1929, no bank made car loans because the collateral, they asserted, could be moved too easily. Consumer loans were not pursued by banks until after World War II. If banks could play a role in the development of new businesses, much progress could be expected.

Real supply side economics would involve new and better relationships between management and labor, designed to increase the productivity of both. An important part of supply side economics includes a viable energy program. An effective energy program would not only serve to make the economy more efficient, but it would do much to improve international relations.

There are many other things that can be done to improve economic conditions. The solutions aren't simple, but they are possible. We should concentrate immediately on making monetary policy and interest rates more consistent with economic growth. This will encourage small, innovative businesses to survive and to bring the benefits of the new technological revolution closer to the heart of American enterprise.

Thank you.

Senator SASSER. Thank you, Doctor Flexner. I'd like to propound two or three questions to you if ~~the rest of~~ our panelists will give me a little forebearance here.

No. 1, that is a very provocative and thought-provoking paper that you delivered. Recognizing that the Federal Reserve Board's monetary growth policies are going to be reduced next year from the present 3½ to 6 percent range to 2½ to 5 percent range for the M_{1B} money supply. Do you agree with economists who say that interest rates will increase more next year, after this fall, and I mean the fall quarter of 1981?

Dr. FLEXNER. Well, first of all, we are in a recession.

Senator SASSER. The President said that yesterday.

Dr. FLEXNER. Yes, but that could have been said even earlier. We are in a recession, and the recession is going to get worse, to the extent that demand for credit will decline. This is going to have an effect on interest rates, but, on the other hand, 1982 is a political year, and I expect that the administration will not want the economy to decline too much because it could cause it a lot of woes. So there will probably be an expansionary effort on the part of the administration, and if the Federal Reserve goes through with what you have just suggested, the decline in the growth of MB-1, then you can expect interest rates to rise higher than they were this year. There's no doubt in my mind that they could go to 25 percent next year if, in fact, the unemployment gets to be around 9 percent by the beginning of the next year, in the first quarter—which is 7½ now, which I imagine it could easily do. Then if the administration tried to lower unemployment prior to the election, they are going to have quite a problem. If they tried to restrict the expansion with tight money, it could lead to very high interest rates.

Senator SASSER. It's interesting to note that Dr. Henry Kaufman, the respected economist, is predicting that there will be a dip in interest rates in the fourth quarter, and then that the interest rates will go up in 1982 to higher than they presently are.

I read yesterday in the New York Times. I think, where Dr. Walter Heller, former chairman of the Council of Economic advisers during the Kennedy administration, and I recall, now a distinguished professor at the University of Minnesota, made a speech in Baltimore in which he took a contrary view that, in the short run, he thought during the year 1982 interest rates would come down, and could come down substantially but would start coursing back upward again then the latter part of 1982 or early 1983, but certainly after the end of 1982.

So what we have there, I suppose, Dr. Flexner, is the opinion of one highly respected economist, Dr. Kaufman, who I'd say is insulated from the political world by his saying that the interest rates will go up next year, and Dr. Heller, who's had some experience with the political world and the way it operates, who is saying that interest rates will come down that year. So my question is, how are our business people going to know how to anticipate or plan?

Dr. FLEXNER. Well, the answer to that is of course, that no fact has a life of its own. When two people interpret a fact, you often end up with two facts. The reason for that is that both people can start from a different point of view; for example, you can defend both positions. Walter Heller assumes that high interest rates are very bad for political reasons, and unemployment is also considered very bad for political reasons. If unemployment continues to rise and the Federal Reserve allows the money supply to grow a little faster in light of the 1982 elections, then what Heller says will be true. But if the Federal Reserve sticks to its promise of keeping M_{1B} to a reclined range, then there will be a rise in interest rates. So Heller might assume the Federal Reserve will not stick to it because of the election, and Kaufman may assume that the Federal Reserve will stick to it and that would explain the difference. In my mind, I would agree a little more with Heller than with Kaufman, because I think elections make economists out of people.

Senator SASSER. I've learned a lot about economics since I got into politics.

Dr. FLEXNER. That's very true. And so I would say this if I were to make a forecast—I don't know whether you wanted me to do that or not, but I would say that I would expect Walter Heller to rescind somewhat on his prediction for the money supply, because, you see, the problem is, you have a recession. Now what do you do during a recession? It will not cure itself, so the Government will probably have to take some action. Now some of that action may come if the armaments program begins to take effect and armaments expenditures start going up, for new hardware—military hardware, that will have an expansionary effect on the economy, and high interest rates may not affect big corporations very much because they can transfer the interest charges. So if they are thinking that way, what will happen is the interest rates could go up next year, and small businesses will go into bankruptcies, but the economy could still look pretty good because of the effect of increased military expenditures. But on the other hand, if the interest rates are very high, the President and his party will have to think about whether that will have an effect on the election. So they may come out with a different decision, which is Walter Heller's thinking; namely, they are not going to be quite as concerned about creating economic stability. They're going to let the money supply rise a little faster, which would keep interest rates lower until right after the election, when they will go up. Because if you keep them low after the election, you will have—with everything that is now being planned, a real catastrophe in the economy.

So the only thing where Kaufman and Heller disagree is timing; Kaufman thinks it will happen before the election, Heller thinks it will happen after the election. I would tend to agree more with Heller, because it's politically more realistic.

Senator SASSER. But in the long term, after 1982, I think you would agree that interest rates are going to go up.

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Dr. **Flexner**. Oh, yes. Interest rates in this country, with the way we are going now, if our program stays as it is, with this complete dependence on monetary policy and the concept of the balanced budget as a panacea, as it is now regarded, interest rates could easily go to 25 percent.

Senator **Sasser**. Thank you, Dr. Flexner.

Dr. Bies?

STATEMENT OF DR. SUSAN BIES, ECONOMIST, FIRST TENNESSEE BANK, MEMPHIS, TENN.

Dr. **Bies**. Senator Sasser, I guess when you get a group of economists here, you don't expect to hear the same thing, and what I'd like to do is give you some perspectives. I notice I'm the only person here also from a lending institution, and I think it would be good both to tie in what my philosophy in the economics is, in the outlook, and also to talk about what we can actually do, and maybe prescribe some actions that can really be taken to get at this root problem of high interest rates and their effect on small businesses.

As you are aware, financial institutions are presently going through dramatic changes in their operating policies, brought about by changes in Federal regulations and recent economic policies.

The major challenge facing the financial industry today is to better meet the financing needs of our customers during these changing times. The major reason for higher loan rates today is the higher interest rates we are paying on deposits. After 45 years of regulation, the Depository Institutions Deregulation and Monetary Control Act of 1980 was passed by Congress to allow the phaseout of restrictions which kept interest rates paid depositors below market interest rates. The intent of Congress was to allow us to finally pay the average American and small business firm interest on their deposits similar to rates which only large depositors were able to receive under regulation Q. The encouragement of additional savings to provide funds for business expansion is an important aim of this policy. Bankers and our smaller depositors were very pleased to see that this discriminatory pricing policy set by Federal regulators would be coming to an end.

Banks are financial intermediaries. That is, we receive deposits from one group of customers and lend these funds to others. Thus, as we pay more for deposits, our loan rates must rise to cover our cost of funds. We are now not only paying more as our deposits shift from 5¼ passbook accounts to 15½ percent 6-month money market certificates, but also the unusually high level of market interest rates further raises our cost of funds. First Tennessee, as an example, became concerned about the impact of high interest rates on small businesses back in 1979, when this cycle first started, and we began, as most businesses do, to try to innovate to serve their customers better when the situations change. We are well aware that a bankruptcy is detrimental to the entire market area, as well as ourselves and the customers. So to help smaller businesses, we instituted a small borrower prime in December of 1979. This special rate is still in effect, and is used to price loans to small businesses—those with net worth below $200,000.

The small borrower prime is tied to our major source of new deposit growth—the 6-month money market certificate. Today, while our base lending rate is 18 percent, small businesses can borrow at a base rate of 16¼ percent. The small base rate is set only 1 percent above the rate we paid on 6-month money market deposits in September. This one point spread is not sufficient to cover our costs of handling both the loan and the deposit, but because of our concern for small business, we are willing to subsidize them through this high-interest-rate period. Further, we are hoping that this will keep them as good customers when the economy improves.

But, we also have the responsibility to our shareholders to earn a profit. If we decide to assist one group of customers through a particularly difficult period, we must earn enough elsewhere to cover our loss on small business lending. This is where you must assist us. Today, the States of Arkansas and Tennessee have some of the most restrictive usury laws in the country. Bankers in these States are caught between the action of Federal regulators to raise rates on our deposits, while State laws prohibit us from increasing our loan rates to cover the higher risk customers. Thus, as lending becomes less profitable, we are forced to severely limit the total amount of assistance to those customers who are hurt the most by high interest rates. To continue to promote fair market interest rates for small depositors, and also to help small business borrowers, we need to have a full Federal override of all State usury laws, and allow lending institutions the full flexibility to serve their markets.

Another fact that has become very evident to us in working with small business is that the availability of credit is more important than its cost. We must keep working capital available to small business, especially during periods of low sales and profits. But when bankers consider where to acquire these loanable funds, we are faced with the problem of regulations preventing us from innovating to serve our customers better. Money market mutual funds are able to offer our depositors a financial investment that is more liquid and pays a higher rate than we can, by law. Thus, our depositors and those throughout the country have made the decision to take funds that would be in depository institutions and place them in money market mutual funds. Over the past 12 months, assets in the approximately 125 money market mutual funds in this Nation have grown by $65 billion. In this same period, the total of all checking accounts, NOW accounts, checking interest accounts, savings accounts, 6-month money market certificates, and all other consumer deposits at a total of 35,000 banks. savings and loans, and credit unions have grown by only $63 billion. Thus, one out of every $2 that would have come to a bank, that would have come to an S. & L. or would have come to a credit union is now in a money market mutual fund.

This means that one out of every two new dollars that could have been used to make a loan to a local business, to a home buyer, or a local consumer, has left our community, because money market mutual funds place their funds in a concentrated market. They are holding U.S. Treasury securities, the commercial paper of the largest corporations in the United States, and the certificates of deposit in only the largest banks in New York, Chicago, and California. As bankers, we are very concerned about this loss of available credit to our local market area, but there is very little we can do right now to fight back to regain our depositors.

If you are interested in getting funds to your constituents, I urge you to support the proposed legislation that would allow depository institutions to offer a deposit instrument that would look like a money market fund to the depositors, but allow bankers, and savings and loans to keep that money and loan it in their area, rather than shipping it out to New York.

This August, First Tennessee Bank also took a further step to try to serve our small business customers, and that was to become a certified lender for the Small Business Administration. This will enable us to give a quicker response to our customers' loan requests, and we have also formed a special lending division, the Memphis division, to deal just with small businesses. Like other financial institutions, what we are trying to do is to innovate and serve small business better. We are well aware that the reduced growth of Federal expenditures is going to limit SBA funding this year, and for that reason we offer a suggestion on better use of the SBA funds. Most losses in the small business program come from the direct lending area. The large defaults on the drought loans made earlier this year in Dyersburg, Tenn., is such an example. After being turned down as too risky by two commercial banks, borrowers can go directly to the SBA for a loan. These very risky loans, which a bank would not undertake, are the ones that normally fail. If funds were redirected to more guaranteed loans made by commercial banks, rather than direct lending, a greater number of businesses could be helped with the same cost to Government. The SBA guaranteed loans permit banks to offer longer-term, lower-payment loans than our standard loan agreements do. Thus, they are directly able to meet small business financing needs.

While high interest rates clearly increase the cost of doing business, our work with small businesses has clearly pointed out that they play but a small role in the financial difficulty today. Further, high interest rates are rather a symptom, but not a cause, of the basic problem—inflation. The economic base in our area is increasingly moving toward being made up of small businesses, and most of these firms are in the new growth industries—trade and services. Unlike the age of manufacturing, they tend to have little in the way of fixed assets; rather they are leasing many of their assets. They are also very people-intensive industries, so that wages play a predominant cost in operation. This means that if wages account for, say, 45 percent of the expenses of a firm, wage adjustments that just keep pace with inflation will cause total expenses to rise by 7 percent. But financing of working capital may amount to only 5 percent of total expenses, and interest could even double and still raise business expense by only 5 percent.

Farmers, nowadays, are primarily using the Farm Credit Bank financing for their loans. Bankers are being priced out of this market because of the below-market rates given by these Federal agencies. The farmers this year are facing financial difficulties, not because of these subsidized below-market interest rates, but rather because of the bumper crop, which has lowered their prices received. This, on top of much higher operating costs—again, due to inflation—has kept their net income from growing for the second year in a row.

Therefore, the most important action you can take to improve profitability for small business is to support programs that solve our chronic problem of inflation. There are no quick fix solutions to the problem. It has been growing for 13 years, but some improvements are already noticeable. Further deregulation of businesses, like commercial banking, will help encourage innovation, which will improve productivity and reduce costs of doing business. We feel the Federal Reserve must continue its policy of restrictive monetary growth. While this will keep interest rates high in the short run, it will help solve inflation problems sooner. Small businesses are able to cope with one short period of high interest rates, but a prolonged bout with interest rates, year after year, is eventually going to sap their financial strength.

Finally, Congress must realize that it can't do everything for everyone. The size of the Federal Government and the deficit directly affects small business, because the Federal Government bids against business for labor, materials, and most importantly, credit. In 1972 to 1974, total Federal borrowing accounted for 12 percent of all borrowed funds in this country. Starting in 1975, the Federal deficit and agency borrowing began to take an increasing share of total credit in our Nation. From 1977 to 1979, the Federal Government accounted for 19 percent of all borrowing, and last year it jumped to 28 percent of all borrowing. In the first half of 1981, the Federal Government is still taking $1 out of every $4 borrowed by American businesses and individuals in this country. Less than 10 years ago, they used only $1 out of every $9. The Federal Government has doubled its share of credit use at the expense of home buyers, auto purchasers, and small businesses, who are crowded out of the market due to high interest rates. The Federal deficit must not be allowed to expand further if lower cost, more plentiful credit is to be made available to small businesses.

Senator Sasser. Thank you, Doctor Bies.

I just might make this observation. You say in your statement that interest rates play only a small part in the financial difficulties of small businesses and farmers today. That's not what they're telling me—what I get across the State—to be perfectly honest about it. They're telling me that the interest rates are one of the principal causes of their problems, particularly those in the automobile business and the homebuilding business. And the cost of money is becoming increasingly higher in proportion to the operating costs of the farmer; is what they're telling me. How do you rationalize that with your statement that the interest rates play only a small role in their financial problems?

Dr. Bies. Well, I think the main thing we have to look at here is how differently financing costs affect different businesses. If you look at an auto agency or a homebuilder, the demand for their products is what is so interest-sensitive. And when a demand for their product is down, they can't afford to keep the people that they have on their payroll employed. Those industries have been hurting, and they've been hurting since 1978. Other industries, on the other hand, have adapted very quickly. These firms have much better inventory control than they used to and as a result they are able to reduce some of their share of interest expense. We have been trying to put together a prototype of small businesses to see if we could identify what an average businessman really pays in interest expense. We found it very difficult in our market area because the small businessman is so diverse. I think the ones that are hurting the most are homebuilders and automobile dealers. But I'd also like to point out, if you look at auto rates, that the interest cost of an auto loan in the last 2 years has only gone up about 2 percent. The cost of the automobile itself has gone up by more than 15 percent a year for the last 3 years. And it's the cost of the car—in other words, inflation, that is much more critical in hurting those automobile sales than the interest cost of financing that loan.

Senator SASSER. The other side of the picture, as far as the auto industry is concerned, is the cost for planning the inventory. Now we're going to hear testimony today, I suspect, in which it will be revealed that the average interest cost per automobile, per unit, a few years ago was $26 per unit per month. Now the same automobile, the interest cost on it is $240 per unit per month.

Dr. BIES. But again, I think it would be useful to look at what the cost of the car that is being financed is versus the difference on the interest rate on that financing. I think you'll find out, from what we've been able to tell, the increased price of the car itself is a major contributor. When you're going from selling a $4,500 car to a $9,000 car, you have the same number of cars that you're trying to finance, but the dollars that you're borrowing and financing has doubled. And that is a major factor that enters into that also.

Senator SASSER. Maybe we ought to reduce the automobile dealer's inventory, and go back to Henry Ford's motto, "You can have any color you want, as long as it's black."

Thank you, Doctor Bies.

STATEMENT OF TERRY BRITT, VICE PRESIDENT, SPARKS COMMODITIES, MEMPHIS, TENN.

Mr. BRITT. Thank you, Senator Sasser. I appreciate being invited to attend this hearing, and participate in trying to answer the question of the impact of higher interest rates and monetary policy on small businessmen and agriculture.

I'm going to talk a little bit about the lender's role, which is one of a financial intermediary, taking deposits, paying a stated rate of interest over a certain period of time, and lending or investing the funds at a profit for the stockholders. Based on supply and demand for funds in a region or national, and even in an international economic environment, lenders compete to grow and prosper in and with their communities based on their view of risk/reward relationships.

Now, the Federal Reserve's role. Its role is established originally by an act of Congress, December 23, 1913, to give the country an elastic currency, to provide facilities for discounting commercial paper, and to improve the supervision of banking. The primary objectives of the Federal Reserve System have evolved over the decades to now include economic stability and growth, a high level of employment, stability in the purchasing power of the dollar, and reasonable balance in transactions with foreign countries.

The Federal Reserve is periodically referred to as independent of the Government. It is perhaps more correct to say that the Federal

Reserve System is independent within government. The system typically works within the framework of the overall objectives of economic and financial policy established by the Government.

The conflict between the Federal Reserve's so-called independence, as a creature of Congress, typically comes when interest rates are high and the Federal Reserve is not accommodating all the credit demands in the economy. Certain sectors of the economy tend to be crowded out and can't get credit at any price. Increased bankruptcies of small to medium sized firms occur, and even some large firms may have trouble finding enough credit. Some merge with stronger, larger businesses; some fail. In recent history, the Federal Government has jumped in and acted as direct lender, or indirectly, to guarantee the paper of a large company—Penn Central, Chrysler—or local government unit, as in New York City.

The major method the Federal Reserve uses to control the supply of money in circulation, the growth of bank reserves and bank credit, is through the purchase and sale of United States Government securities, T-bills, Treasury notes, Treasury bonds. When the Federal Reserve buys securities, it adds to the money supply; when it sells securities it already owns in its portfolio, it drains money from the banking system.

The laws of supply and demand work in the credit markets in a way that generally hurts the smaller businessman, farmer, single proprietor, the individual, first and with the greatest impact. It usually works like this. As economic activity intensifies and growth speeds up, the demand for credit also increases. As demand for credit continues, the Federal Reserve becomes less generous in supplying bank reserves, and lenders generally begin to raise interest rates and become more restrictive, turning down new loans considered marginal and loan requests with companies that don't have solid deposit relationships with them. Lenders might also suggest highest compensating balances to somewhat discourage borrowers. Eventually, the lenders will begin liquidating a portion of their investment portfolio to obtain more lendable funds for their customers. Fairly shortly, the liquidity of the investment portfolio is being eroded, and the investment officer is taking losses when he sells some investments.

The lender will continue reduction of the liquidity portions of the investment portfolio as long as the return on the loan to a businessman, an individual, a farmer, or to improve the local economy will expand the base of business and increase growth and profit potential for the institution over and above the loss on the sale of the investment. The lender attempts to insulate the borrower from the impact of tight money—high rates—as much as he can by reducing the investment portfolio so he can accommodate his borrowing customers.

There is a limit to which each institution can continue this process. At some point, it is no longer possible from the point of view of overall long range profitability to sell any more investment securities. The loan income—immediate and long range—that would accrue from converting these funds from investment to loans would not be able to cover the losses involved in the sale.

Though interest rates are usually rising during this process, sometimes the higher rates fail to slow down the demand for credit sufficiently.

Money market rates and capital market rates have risen because of fewer lendable reserves at banks and thrift institutions, and in response to the selling activity of the investment officers—as security prices fall, interest rates rise.

It is at this stage that the allocative process becomes binding. If price—high interest rates—hasn't brought supply and demand into balance, each lending institution must place restraints on availability. Someone, or some sector, of the credit market must be squeezed out because the lendable funds are just no longer there.

Lenders try their best to accommodate their valued customers, but if they are forced to limit availability then they must choose. They will try to allocate funds to meet the best interests of their local or regional economy at that particular point in time; projects that will expand productive facilities versus financing takeovers of a corporation or a speculative purchase of inventory.

They will upgrade the quality of loan portfolio, reducing or eliminating the more marginal borrower. They will allocate funds to borrowers that will help maximize the long run profitability of their institutions.

Typically, the construction industry is the first sector to feel the squeeze, with spillover into some durable goods businesses and real estate markets.

New businesses suffer, versus more established firms; large businesses are favored over the small busines operations. Heavily leveraged farmers may find it difficult to borrow. But the fact that these classes of potential borrowers are hurt more than others is the price that an economy must pay for the free market decisionmaking about how tight money effects will be felt.

It is important to note here that our Government, through its deficit financing program, is usually the largest borrower as rates are peaking as in current levels.

Raising interest rates, the price of credit, or choosing sectors that are denied the availability of credit are, in the final analysis, the free market mechanisms our society still wants to use to attempt to reduce inflation, or inflationary pressures.

Now, recent news reports suggest that Americans' No. 1 concern is the high level of interest rates. A few months ago, it was inflation. These public concerns are especially interesting because the two problems are interconnected. One is the short-term remedy for the other.

Starting with inflation, because that is where the seeds of today's interest rates were sown, let us examine how we got into this present mess. Quite simply, inflation is caused by too many dollars chasing after too few goods and services. For many years now, the Government has attempted to purchase goods and services, for whatever reason, without raising taxes to pay for them. As a consequence, the Government has had to get into the credit market to obtain the dollars needed for these expenditures. Large Government borrowing would normally have been expected to raise interest rates, but the Federal Reserve, in an attempt to protect the private borrowers from the stress of high interest rates, accommodated this Government borrowing by increasing the money supply. In doing so, they kept interest rates down in the 1960's and the early 1970's, but also insured that prices would begin to accelerate later. So, in effect, we're paying for that price right now.

We have recently made the decision to fight inflation. To do that, we must slow that parade of dollars. that is, reduce the rate of the money supply growth. The Federal Reserve has set out to do just that. Now the Nation's money supply is growing less rapidly than the demand for money. The consequence is high rates of interest.

A restatement of our inflation generating hypothesis might be that inflation is caused by individuals and institutions trying to buy more goods and services than can be produced. Clearly, not everyone can get what he or she wants. Someone must come up short. It will either be the Government—reduced Government spending—the taxpayer, higher taxes; or credit market participants, higher interest rates. There are no noninflationary alternatives.

Now, despite the fact that this system is still in use, it doesn't stop or limit the attempts of many to place the blame, or as I sometimes say, kick the dog. At this time of the business cycle, it is normal to expect a lot of rhetoric about who or what is to blame for high interest rates and crowding out. Quite often, the Federal Reserve is on the receiving end, and the rhetoric may be from the sincere individual denied credit, the farmer, the small businessman, even the Treasury Department, an administrative spokesman, the President, and even a Senator or a Representative of the House have been known to direct our attention to the Federal Reserve as the cause of all this credit restraint and high interest rates.

We should accept at this stage that some borrowing must be restrained if we are to avoid inflationary pressures in the U.S. economy. High rates due to tight money are a necessary evil in fighting inflation, in the absence of sufficient fiscal or governmental restraint. We need to stop trying to find the culprit so we can point fingers and raise Cain at them or it, the cause. We are collectively the problem. We have allowed our Government to overspend, year after year, billions of dollars, thereby cheapening the dollar's value. We've delegated to Washington thousands of decisions we should have made at the local and State levels.

Years and years of deficits, free wheeling Government spending to solve all our problems immediately by throwing dollars at them have forced—and "force" is an important term here—have forced the Federal Reserve System over the years to indirectly monetize the U.S. debt by printing money at a rate that is faster than our economy can produce real goods and services. The result is inflation. Whether intended or not, we have debased our currency. Each year our dollars buy less and less.

The real underlying question becomes, will we, the people, continue to allow our Government to try to use deficit finance, spend its way to prosperity, when the reality is, it cannot be done. The Government has given us fiat currency with these deficits. Fiat currency is defined as "money (paper currency) that is not convertible into coin or specie of equivalent value and thus is dependent for its value on the decree of the government." The real issue becomes, is the policy of the United States of America, in fact, to continue to have as its national policy, "Fiat currency is OK." If not, then it must be that our national policy should be, "We are a country that believes in a strong currency, and our direction is toward a hard currency."

A quick aside is perhaps in order here. The U.S. Treasury Department is in the final stages of making the second greatest mistake in the coinage segment of our national monetary system in the last several decades. And the Congress is poised to approve their plan. Their first mistake several years ago was to mint a dollar coin with minimal real metal value—the public did not buy it. Now the penny is under attack. Within just a few months, unless convinced otherwise, even the lowly penny will be completely valueless from the metal it contains; now 98 percent copper will become 98 percent zinc, with a thin coat of copper covering. It is terribly ironic that at the very point in our history that we should be taking action to strengthen our dollar and our coinage, that the humble penny is about to fall into the class of the rest of our coinage—a token—it will look very much like a real penny, but the metal value, real value, is worth much less than the nominal monetary value.

In your letter to us, you asked if we could address the question, "Where do we go from here?" Step one is to admit that it is time to roll up our sleeves and begin to define and solve these issues. A problem well-defined is half solved. The time for political games playing is over. New priorities are needed. Balance the budget is No. 1. No. 2, place all off-budget financing within the U.S. budget. No. 3, reality requires that we admit that we cannot achieve every social and economic plan, or perceived need at once. Lower the defense budget—$10 billion, $5 billion, whatever billion you wish, but lower the defense budget in 1982—defer some of those projects, or stretch them into 1983 and 1984.

The Nation and the people, No. 4, need to get back to the basics, such as pay as you go, hard work is honorable, thrift is good. We had a beginning in the thrift incentive with the All-Savers Certificate. The next step would be, eliminate all taxes, Federal and State, on savings accounts so capital formation has the incentive to grow faster. Admit to ourselves that our time horizons on national political economy measures has been too short term, and must be placed out past the time of the next election.

No. 5, the basic requirement is the realization that all social and economic programs entail a cost which must be paid for in one form or another. There is no such thing as a free lunch. If this realization becomes prevalent and if the costs become clear, there will be no need for the Federal Reserve to monetize huge Government deficits, because the deficits will fall.

Neither will it become necessary for maintaining interest rates at some predetermined high level. In short, there will be no need to fool the electorate.

In closing, this would free the monetary authorities to control the growth of the money supply, keeping it at a rate consistent with the rate of growth of the real gross national product, and eliminating the major cause of both inflation and demand induced recession.

Now, in addition, I just want to say that I've given you three articles that are basically copied from their sources. One which is entitled "The Natural History of Money and Credit" from January of 1980, Conference Board Publication, "Across the Board," pages 63-73; an article called "Eliminating Runaway Inflation: Lessons from German Hyperinflation" from "Essays on Inflation," second edition, from the Richmond Federal Reserve Bank. And a chapter out of a book called "The Reigning Error: The Crisis of World Inflation," 1974 edition, William Rees Mogg, the author; and the fourth chapter in that book is entitled "The Case for Gold." Now, I'm not a gold bug, and that's not the purpose for this hearing, but in these three articles, I think you or your staff will find a lot of good information, a lot of quality information; some of the best articles I've seen in my readings over the past 5 or 6 years.

So I will close with again repeating the fact that our country has gotten to a crossroads, and there is no such thing as a free lunch. We've got to roll up our sleeves and start solving the issues now, instead of delaying solving them.

Thank you very much.

Senator SASSER. Thank you, Mr. Britt.

[Material follows:]

Just what is it that gets borrowed and lent?

The natural history of money and credit

by Ashby Bladen

The intuitively obvious answer to the question of what it is that gets borrowed and lent is, of course, money. That *seems* obvious because we are in the habit of measuring and recording financial transactions in terms of monetary units; but after pondering the matter for much of the last two decades, I find that answer so ambiguous as to be virtually meaningless. It also has implications about the ways in which our financial system works and can be controlled that I believe to be incorrect.

Money with intrinsic value

Let us start by taking a look at the evolution of money. In primitive societies whatever real good proves easiest to transport, store, and exchange gets used in ways that we would regard as monetary transactions. Livestock and grains have frequently been so used, as well as precious stones and metals. In time, however, gold and silver in the form of bullion or coins guaranteed to be of standard weight and fineness by the sovereign or the state proved to be so much the most convenient kinds of money that they became nearly universal.

Note that the kinds of money that we have talked about

Ashby Bladen is senior vice president–investments, The Guardian Life Insurance Company of America. His article is drawn from How to Cope with the Developing Financial Crisis *by Ashby Bladen. Copyright © 1980 by McGraw-Hill, Inc. Reprinted by permission of the publisher, McGraw-Hill Book Company.*

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A goddess and money—*Moneta* in Latin meant an adviser, a term applied to the goddess Juno. The word came to relate to money because Roman coins were minted in Juno's temple.

ARTICLE, THE NATURAL HISTORY OF MONEY & CREDIT
January 1980, Conference Board publication, Across the Board, Pg. 63-73

so far consist of real things and can be considered to be commodities as well as money, so that when the stock of money that possesses tangible value increases, the stock of real goods also necessarily increases by the same amount. A large increase in the production of gold or silver might cause the prices of other goods and services to rise relative to coins and bullion, but a more accurate way of describing the situation would be to say that the increasing availability of precious metals was causing their prices to fall. Attempts were certainly made from time to time to create purchasing power out of thin air—that is, without also working to produce an equivalent amount of real goods and services. It was done by clipping or alloying the coins, but that was an entirely different and enormously less efficient process than the modern inflationary abuse of the financial system. So let's move on to credit money.

Credit money

The next major step in the evolution of our present financial system resulted from the fact that, although coins and bullion were the most convenient forms of money with tangible value, they still left a good deal to be desired. Large amounts of them were heavy, and their value made it necessary to keep them in a safe place. Most people didn't have safe places, but goldsmiths, by the very nature of their business, did. So people fell into the habit of leaving their gold with the local goldsmith in exchange for a paper receipt. Then merchants in the neighborhood who knew and trusted the goldsmith adopted the habit of accepting his receipts in exchange for real goods and services; thus turning them into a paper money that did not possess, but that was backed by, tangible value. And finally, as the system evolved, the goldsmiths realized that, since little if any of the gold ever left their vaults while their receipts were accepted as representing real purchasing power, they could earn an interest income either by lending out some of the gold or by issuing additional receipts in exchange for a note of the borrower instead of gold. That was the origin of the modern system of fractional-reserve banking—a system that until fairly recently was still based upon tangible value, but in which the tangible assets of the financial system were no longer sufficient to pay off all of its liabilities. From that time on the financial instruments that were accepted as embodying purchasing power were based more and more upon credit—that is, on faith in somebody's future ability and willingness to repay—and less and less upon intrinsic value.

Constructive versus inflationary uses of credit

As long as the credit thus created was extended only to responsible people who had an opportunity to invest it in the tools and machines that make human efforts more productive, all was well. The resulting increase in real output enabled borrowers not only to repay the purchasing power that had been lent to them but also to pay a reasonable rent for its use. The fundamental cause of the accelerating inflation and worsening financial difficulties that we are enduring today is the fact that more and more of the credit that is being created at a rapidly rising rate is going to finance consumption, and incomes for people who do not produce a corresponding amount of real goods or services, and less and less is going to finance real investment in productive assets. Thus nominal demand is growing at an increasingly more rapid clip than is the supply of real goods and services.

Modern politics—the art of promising the ultimately impossible

The chief offender in this respect is the political system. In modern social democracies, politics has become an art not of the possible, but of making promises of economic and social benefits that are often completely divorced from any responsible consideration of the practical possibility of fulfilling them in real terms. The attempt to appear to fulfill them, by creating nominal incomes at a rate substantially faster than that at which real output and real incomes are growing, is causing the great majority of national governments to run large and secularly increasing budget deficits that in turn produce rates of inflation, and consequently levels of interest rates, with which the financial system, as it is now constituted, cannot in the end coexist. The substitution of government financing for the present financial system, which is based upon personal savings—a process that is already well under way in most countries—is also virtually certain to continue to produce both accelerating inflation and a decline in the rate at which the productivity of the real economy is advancing. If it goes far enough, it can cause an actual decline in productivity.

Next to war, this is the most serious problem facing modern society. Faltering productivity, accelerating inflation, and soaring interest rates have already caused steadily worsening economic and financial troubles; they are capable of producing a disaster if their causes are not identified more accurately than they generally have been to date, and if prompt steps are not taken to correct them. The philosopher Hegel used to say that the owl of Minerva flies at dusk, and it may be the case that we will achieve an accurate understanding of the way our financial system works only as it is passing from the scene.

Early forms of credit money—bubbles, assignats and Continental dollars

In addition to the deposit receipts that we have already discussed, there is another and more disreputable forerunner of our modern financial instruments. During times of war, monarchs and national states often mobilized the resources of their people by offering them in exchange notes of the state that were to be paid off at some time after the war was over. Often force and fraud were more characteristic of these loans than was confidence in the borrower. When Ethan Allen asks you to patriotically sell your horse to the revolutionary forces, proffering a fistful of Continental dollars in one hand and a horse pistol in the other, you are not likely to keep him waiting too long while you ponder the odds that after the war the Continental Congress will be able to make good on its wartime debts. The Continental dollars were supposed to be redeemed eventually with Spanish silver dollars, which in the 18th century were the most common and universally accepted examples of money with intrinsic value; but of course neither the Continental Congress nor the individual states had any significant amount of silver dollars, or any plausible way of getting them. During the declining years of absolute monarchy in the 17th century, this type of finance was common in France and Spain, and, to a somewhat lesser extent, in Britain under the Stuarts; and, of course, it was revived in the 18th century by the revolutionary governments in the United States and France.

The Money Changers—In the evolution of a money system "people fell into the habit of leaving their gold with the local goldsmith in exchange for a paper receipt."

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Painting by Massys, Flemish school, 15th century

The consequences of forcing people to hold their savings in the form of claims against the government, whose real value was doubtful, ranged from bad to disastrous. In Spain the national credit was virtually destroyed, and it has not yet entirely recovered. In France the chaotic state of the national finances at the beginning of the 18th century enabled a remarkable Scottish financial adventurer, John Law, to attempt to pay off the national debt by exchanging it for shares of the original concept stock—that of the Mississippi Company, which had been granted a monopoly on trading with the colony of Louisiana. As long as the stock went up, so that people who had taken it in exchange for their claims against the government showed a large profit, the scheme worked; but in 1720 some sailors who had actually been to Louisiana returned to Paris and spread the word that it was not Golconda but a pestilential swamp. The resulting crash, followed three quarters of a century later by revolution, hyperinflation, and the collapse of the financial system, left the French with an abiding mistrust of financial instruments and institutions; and the resulting limited availability of long-term credit has always kept the French economy from developing its potential to the same degree that countries with basically British financial institutions have done.

The first American hyperinflation

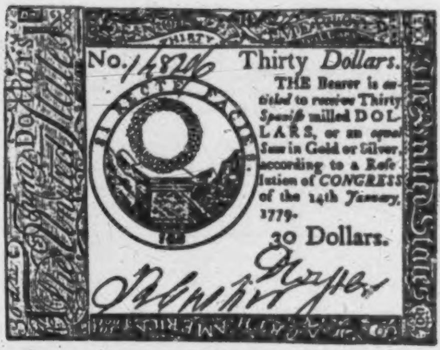
A similar bubble popped at the same time in England. By then, however, Britain had become a stable constitutional monarchy and generally followed the sound principles of Dutch finance that William of Orange brought with him when he became king, so that it avoided the chaotic financial conditions characteristic both of the earlier Stuart era and of contemporary France. The United States was probably saved from the worst effects of revolutionary finance by the fact that it was predominantly a nation of subsistence farmers; the hyperinflation of the 1780s affected mainly a handful of merchants and bankers in the cities along the East Coast. Nevertheless, the experience left the American people with a respect for sound national finance that lasted for nearly a century and a half, and gave us the picturesque nickname shinplaster for the currency issued by the revolutionary Continental Congress. In 1790 the Continental currency was redeemed by being exchanged for government bonds at the rate of 100 Continental dollars for each one dollar principal amount of the new bonds.

Financial institutions and the credit system

I do not mean to imply that all financial disasters have been caused by irresponsible government financial policy. Two of the great ones—the crash following the wild speculation in tulip bulbs in Holland during the 1630s and the South Sea Bubble in Britain in 1720—both appear to have been primarily the results of rising private wealth and savings at a time when sound investment outlets were scarce and facilities for investigating proposed investments were virtually nonexistent. Indeed, throughout the 18th century, as Britain grew steadily wealthier the country was almost constantly bedeviled by speculative promotions.

The answer to this problem emerged during the 19th century in the form of the enormous growth of financial institutions. The historical roots of modern financial institutions extend well back into the early years of the Renaissance, but until the end of the Napoleonic Wars in 1815 they were of interest primarily to the relatively few people who were involved with industry and commerce, while the bulk of humanity was still engaged in subsistence farming. During the 19th century, however, the rapid growth of manufacturing industry and of commerce caused an enormous increase in human wealth, while the success of the European nations in acquiring colonies all over the world caused the great majority of the human race to be exposed to the latest political and financial practices to an unprecedented degree. Thus, in the years before World War I a worldwide financial system had evolved that was based upon the belief that money consisted essentially of coins or bullion that represented purchasing power because they were inherently valuable; but that had also developed a sophisticated and highly efficient method of investing in productive enterprises through the medium of financial promises to repay purchasing power in the future.

Before 1914 the monetary and the financial systems were compatible


No. 148206
Thirty Dollars.
THE Bearer is entitled to receive Thirty Spanish milled DOLLARS, or an equal Sum in Gold or Silver, according to a Resolution of CONGRESS of the 14th January, 1779.
30 Dollars.
The United States
Thirty Dollars
DEPRESSA RESURGIT
1779
The Bettmann Archive

"Shinplaster"—A specimen of Continental currency. In 1790, 100 Continentals were redeemed for each one dollar principal amount of new government bonds.

Financial institutions were crucial to the working of this dual system in several respects. First, they accepted the individually small savings of people who were producing more than they were currently consuming and lumped them together into usefully large agglomerations of capital. Second, they retained staffs of professional investment experts whose function was to determine which of the various proposals for productive investments were in fact likely to increase human productivity by an amount sufficient to repay the savings invested in them along with a reasonable rent for their use. And, finally, they gave savers a reason to believe that the fruits of their own productive efforts that had been invested in productive enterprises through the medium of intangible promises to repay in the future still retained a real tangible value because the liabilities of financial institutions were generally payable either in the form of further financial promises or in the form of money with tangible value. In the normal course of events, and when confidence in the stability of the financial system was unshaken, creditors of financial institutions would usually draw checks upon their balance to pay their debts and to buy real goods and services; but if you ever got worried about the soundness of this complex system, you could always go down to the bank and take out your balance in the form of precious metals.

If this arrangement had been deliberately and consciously devised, it would have been hailed as a stroke of financial genius because it made inflation, in the modern sense of the word, mechanically infeasible. But, it simply evolved out of the efforts of practical men trying to find a better, easier and more profitable way of doing things. (In fact, most effective financial arrangements evolved in just that fashion. Those that worked well were continued and those that didn't were abandoned.)

It worked spectacularly well. Indeed, during the hundred years between the end of the Napoleonic Wars in 1815 and the outbreak of World War I in 1914, the general price level fell gently but persistently, leading to a declining trend in interest rates that rewarded holders of long-term financial instruments with a large profit in nominal terms, and an even larger one in real terms.

Since then the inflationary overissue of financial claims has driven money with intrinsic value from the scene

If one takes August 1914 as marking the dividing line between them, the contrasts between the 19th and the 20th centuries are striking. In many aspects of human

Endangered species?

Is cash becoming passé? Will little plastic credit cards eventually replace paper money? Another step toward just that end was seemingly taken this past fall in New York City.

Mayor Koch last October signed into law a measure that allows motorists to pay their parking fines or towing charges with a credit card. Noting that bad-check losses had cost the city $73,000 in lost revenues in fiscal year 1979, the mayor stated that these losses could be cut considerably through the use of credit cards.

"Allowing the use of credit cards," said Mayor Koch, "will not result in any additional cost to the city, since [the law] permits the city to pass along to the credit card user the fee it will pay to the credit card company."

affairs there has been a complete reversal of trend. For example, before 1914 colonization and the political and military leadership provided by Great Britain caused a progressive improvement in civil order and personal security throughout most of the world. After that year, two World Wars and the Cold War—which have left the world awash in arms, decolonization, and the failure to maintain world leadership, first by Britian and then by the United States—have produced a disastrously declining trend in order and security that has already condemned millions of people to untimely and miserable deaths.

In the financial world during the 19th century, the existence of a monetary system based upon money that possessed intrinsic value alongside a financial system that mobilized the world's steadily growing savings and invested them in the construction of the productive facilities of industry and commerce stimulated a great increase in world prosperity, a declining general price level, and a considerable degree of long-run financial stability. (This longer term stability contrasted with occasional short-run financial crises or panics.) In the 20th century, money with intrinsic value has disappeared completely. The financial system of intangible claims has continued to grow enormously, and has also continued to foster an increase of general prosperity in those parts of the world that are still sufficiently peaceful to make that possible; but it has also produced a wildly fluctuating and now sharply rising trend of prices, a wildly fluctuating and now sharply rising trend of interest rates, and rapidly increasing financial instability.

The disappearance of money with intrinsic value

There are many reasons for this fundamental change in the financial environment, but clearly one major reason was the severance of the linkage between the financial system and money with intrinsic value that began in 1914. When the World War broke out, many of the combatants suspended the convertibility of financial instruments into gold, and asked their citizens to surrender their precious metals in exchange for paper credit money, as measures of war finance. Once again, the consequences of financing war through irresponsible short-term borrowing, rather than through mobilizing the real savings of the people by selling them long-term bonds without permitting them to make offsetting increases in their short-term indebtedness, ranged from poor to cataclysmic. The countries that lost the war—Germany, Austria and Hungary—experienced ruinous hyperinflations during the next five years that destroyed the accumulated savings of the more stable elements of their societies, and that contributed greatly to the collapse of the democratic governments that were imposed upon them by the victorious Allied Powers. The ultimate consequences during the next quarter century included political and social chaos accompanied or followed by dictatorial governments, another World War, and another bout with hyperinflation during the 1940s.

In the United States the breaking of the linkage started later and took longer than it did in Europe—partly because the burden of World War I upon its financial system was not as great as it was in Europe, and partly because of the historical accident that it had a dual monetary system based upon both gold and silver. The United States went off gold internally in 1934 as part of a policy of deliberate "reflation," and it was forced off silver by a run on the Treasury's silver supplies that coincided with the onset of serious inflation in the mid-1960s. Externally, the United States dollar remained formally convertible into gold until 1971, but after the mid-1960s, only on the condition that nobody actually try to convert.

The breaking of the linkage was a momentous event. Before 1914 inflation was almost exclusively a war-related phenomenon. Governments have almost never been willing to pay for wars entirely through open and aboveboard taxes and through mobilizing the real savings of their people by selling them long-term bonds without permitting them to borrow against the bonds. During the 19th century it was customary to "go off gold" at the outbreak of war, but to go back on it when peace and financial stability had been restored; and responsible governments tried to return to the gold value that their currency had had before the war started by offsetting the war's inflation with a peacetime deflation.

The case of the American Civil War is particularly instructive. After the country (the North, that is) went off gold and started printing paper money, inflation reduced its value to the point at which $2.33 in paper equaled $1.00 in gold in 1864. Nevertheless, the Federal government was able to finance the war at an interest cost that ranged between 5 and 6 percent—very modest rates considering the inflation, the desperate nature of the war, and the initial uncertainty that the Union would win. Part of the reason was that government bonds were valuable to banks as collateral backing up their own issues of bank notes. More important was the fact that astute people expected that after the war gold convertibility would be restored at the prewar parity so that buying government bonds with depreciated greenbacks would turn out to be very profitable in real terms; and by 1880 that is indeed the way it turned out. Can you imagine anyone, anywhere, today expecting any government to be that responsible?

> ***Money is by nature gold and silver.***
>
> **—Karl Marx**

By the mid-1960s the inflationary proliferation of credit instruments had, in accordance with Gresham's Law, driven money with intrinsic value off the financial scene by causing people to hoard coins and bullion, thereby making the convertibility of bank notes and other financial instruments impossible to maintain in the face of the growing demand for precious metals that could be trusted to at least maintain their real value. Virtually everything that we now use to settle transactions is an inconvertible financial instrument of one kind or another. The things that are called money today are simply the most liquid—that is, the most easily and conveniently spendable—of the financial instruments in the system. In the United States, for example, now that both gold and silver certificates are gone and gold and silver coins are carefully hoarded treasures, the dollars that remain are merely evidence of a non-interest-bearing debt of one or another of the regional Federal Reserve banks. Our present coins are only tokens that look like the old silver coins, but are usually worth much less as metal than their nominal monetary value. (One exception is the copper penny, which occasionally causes a problem by becoming worth more as metal than as money.)

Money no longer exists

This fundamental change, without which the accelerating inflation and growing financial instability of the late 1960s and the 1970s would not have been possible, has received surprisingly little theoretical attention from respectable economists. (There are a number of people who consider the change to be of major importance, and who believe that financial stability cannot be restored until we "go back on gold," but most academic economists consider them to be rather disreputable characters.) One of the major theoretical consequences of the disappearance of money with intrinsic value is that the verbal distinction that we continue to make between money on the one hand and credit on the other no longer represents a real difference. I repeat that everything we use today to settle transactions is a credit instrument—an evidence of a debt. Therefore, I propose to banish the word "money" from our technical vocabulary. It stems from the Latin *moneta*, which means coins*; and after more than two millennia of signifying intrinsic value it has connotations that are mischievous and misleading in a world from which real money has vanished altogether. A good substitute is the word "funds," which, at least in British usage, is associated with the concept of debt rather than that of money with intrinsic value. When we are talking less technically, the use of the word "money" is convenient and does no harm as long as we remember that its meaning has completely changed since 1914.

The German hyperinflation

One of the minor consequences of the failure to realize that once money with intrinsic value has gone the discrimination between money and credit becomes a distinction without a difference is that the catastrophic inflation that afflicted Germany between 1914 and 1923 is almost universally misinterpreted. It is generally considered to be a classic example of a printing press, paper money inflation. I maintain not only that the distinction between money and credit was obsolete in Germany after August 1914 but also that the enormous expansion of the nominal value of the bank notes outstanding was not a fundamental cause of the inflation. (It was, of course, a contributing factor that permitted the inflation to continue for longer than would otherwise have been possible.)

Before 1914 the German currency consisted both of gold coins and of Reichsbank notes that, like all self-respecting 19th century paper currencies, were freely exchangeable for gold. Under the terms of the Bank Law of 1875, which was still in force in 1914, the Reichsbank

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*A note for the etymologically inclined. *Moneta* in Latin originally meant an adviser, and it was a complimentary term applied to the goddess Juno, who was piously considered to be an adviser to the Roman state. It came to be associated with money because the Roman coins were minted in the temple of Juno the Adviser.

A 1913 French gold coin

"In both theory and practice, the 19th century financial system was based upon money with intrinsic value. . . . August 1914 marked a radical, and in the end catastrophic, transformation of that system."

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German soldiers on the way to the front in the First World War

had to maintain a gold reserve equal to at least one third of its notes outstanding. The rest of the backing for the currency could consist of three months' commercial bills that were supposed to finance physical inventories of real goods that were moving through the distribution system toward the ultimate buyers, and those bills had to be guaranteed by reputable businessmen in order to be eligible as collateral securing the Reichsbank's note issue. It was expected that the Reichsbank's holdings of these bills would fluctuate seasonally and cyclically as the Reichsbank discharged its responsibility for financing the short-term requirements of the business community. These provisions are typical of both the theory and the practice of the 19th century financial system that was based both upon money with intrinsic value and upon credit that was intended to finance real productive activity—the financial stability of the system being assured by the convertibility of financial assets into money with intrinsic value.

1914 marked a radical, and in the end catastrophic, transformation of that system. At the beginning the Germans expected the war to last for six weeks, after which they would make the French pay for it in the form of reparations in gold, and perhaps physical goods, as they had done after the Franco-Prussian War. Therefore, they viewed the question of war finance as a matter of dealing with a short-run emergency that would not require a major mobilization of the real savings of the German people. So the first steps that were taken in August were essentially temporary expedients. The convertibility of Reichsbank notes into gold was suspended, and people were exhorted to turn in their gold marks for paper ones as a patriotic duty. The Reichsbank was authorized to issue bank notes secured by Treasury bills as collateral (that is, to make unlimited short-term loans to the government)—something that had not been permitted previously—and new loan banks were established to make loans to governmental bodies, to war contractors, and for the purchase of war bonds. The notes of these new banks were to circulate as legal tender. Thus the war was primarily financed not by taxes and the investment of real savings in long-term bonds but by short-term borrowings. After 1916 taxes were raised, but the revenue they produced was very small. More than 60 percent of total German government expenditures during the war years were financed by borrowings. The consequence was that both the internal and the external value of the mark fell by about one half between the beginning of 1914 and the beginning of 1919. The German standard of living also declined by about the same amount. Undoubtedly one of the reasons why Germany lost the war was that the servicemen, who were on fixed pay, knew that they would come out of it poor men.

The Armistice, and the subsequent Treaty of Versailles, required Germany to surrender a vast amount of war matériel, including a great deal of badly needed transportation equipment; stripped the country not only of its colonies but also of about one seventh of its domestic territory, including some of its most productive industrial and agricultural regions; and also required that the German army be rapidly shrunk by 75 percent. These provisions would have caused a further fall in the German standard of living and created a massive unemployment problem—in a country whose social fabric had already been severely strained—even without the added burden of reparations. On top of all that, the Treaty of Versailles required that the German Federal government be democratic, and that it guarantee democratic government to each of the constituent states. (I am using the word "states" in its American signification. The equivalent German word is *länder*.)

Now, the question of political democracy had been settled in the negative in Germany by the failure of the 1848 revolution, after which German political democrats emigrated to the United States where they did many useful things, including the founding of the Guardian Life Insurance Company in America in 1860.

The net result was that a weak and unpopular government had to attempt to deal with the problems of an impoverished and disorganized country that was already suffering a serious inflation that had been caused by irresponsible war finance, and that had also had an enormous external debt imposed upon it. The situation was further complicated by the fact that Germany had had no significant experience of inflation before 1914, and so most people completely failed to understand what was happening. They thought that the prices of goods were going up because of the Allied blockade during the war and the postwar anti-German machinations of the Allies, not that the value of the mark was going down.

Weak governments faced with intractable problems generally believe that they must create all the purchasing power that the market demands. Since it is much easier to create purchasing power than it is to create real goods and services available to be purchased, the inevitable result is inflation, which politicians blame on anything and everything but their own financial policies. The Weimar government was no exception. There were the Allies to blame, and the external depreciation of the mark that resulted from the fact that Germany was running a balance-of-payments deficit and making large payments abroad at a time when astute international traders and foreign exchange dealers realized that the viability of postwar Germany was doubtful in the extreme. As a matter of fact, between the end of the war and the final collapse late in 1923, the external value of the mark fell faster than its internal value, so that Germany was a bargain hunter's paradise for anyone with access to foreign funds.

Certainly the president of the Reichsbank, Dr. Rudolf Havenstein, believed that the constant rise of both domestic and import prices made it imperative to maintain German purchasing power by increasing the supply of money and credit correspondingly, and he boasted of the efficiency of his presses in cranking out bank notes. This attempt to maintain some reasonable part of the nation's real purchasing power by continuously accelerating the creation of nominal purchasing power failed dismally. By the time that total disaster impended, during the dark days of Ruhrkampf†, the real value of the average wage had fallen to perhaps 20 percent of the 1913 level, and clearly to below the subsistence level. The real value of the currency in circulation, however, had fallen to about 3 percent of the 1913 level. The increase in the nominal value of the currency in circulation was fantastic, but the inflation proceeded even faster. The velocity of circulation approached its physically possible limit as workers were paid daily, and given the next half hour off to spend the money; but in fact during the last few years of the inflation there was a chronic shortage of money because it could not be printed fast enough. Municipal governments were authorized to print their own emergency money; toward the end many businesses that enjoyed a good local credit standing printed their own money illegally because they had to pay their workers with something. Moreover, when stabilization came the printing of money did *not* stop—during the following months the supply of legally authorized money multiplied several times again, but prices stabilized and then fell sharply.

It seems quite clear that the chief cause of the German hyperinflation was not the increase in the money supply, fantastic though that was, but the ready availability of credit—first to finance the war, and then to finance the inflation-hedging that developed on an enormous scale once astute people began to realize what was going on. In 1922 and 1923 the Reichsbank rediscounted everybody's notes freely, and at an interest rate of 5 percent per annum until July 1922. After that it raised the rediscount rate by steps up to 90 percent per annum in September 1923—when the inflation rate was on the order of 25 percent *per day*.

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†At the beginning of 1923 the French occupied the Ruhr in order to collect the reparations that the Germans had not paid out of the production of that coal mining and industrial region. The Germans were in no position to resist the occupation by military measures, so they decided to frustrate the French by means of a general strike supported by transfer payments from the rest of the country. It was this attempt, on the part of a nation already impoverished by a decade of war and postwar disorganization, to support 6 million people in unproductive idleness, that pushed Germany over the brink into hyperinflation.

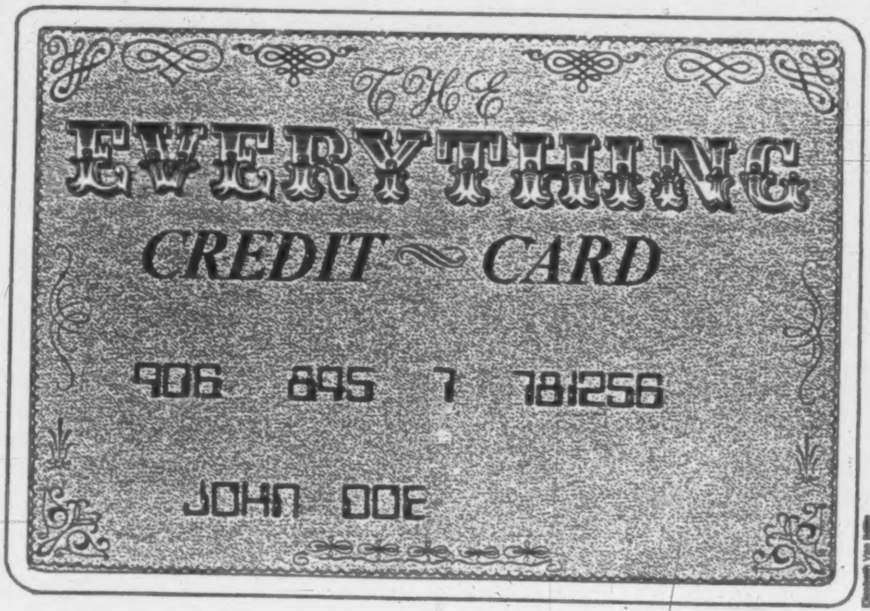
By late 1923 urban Germany was beginning to starve because its wage earners were being paid in a rapidly depreciating credit money that the farmers would no longer accept in exchange for food. The signs of imminent collapse were everywhere. Government revenue now covered 3 percent or less of expenditure. The Ruhr was full of mobs of desperate looters, and violent crime was rising throughout the country.

At the end of September the government recognized that it would have to abandon the Ruhrkampf, and the realization that the struggle and sacrifice had been in vain touched off a political crisis that threatened to tear Germany apart. Separatist movements broke out in several parts of the country, and those in Saxony and Thuringia had to be put down by military force. Hitler sensed that the bottom had been reached and staged his unsuccessful putsch in Munich on November 8.

The stabilization

It was in this disastrous situation that Dr. Hjalmar Schacht became Commissioner for the National Currency on November 13, and he had no attempt at a "soft landing" out of inflation. A new bank had been established to issue a currency called the rentenmark that was secured by corporate bonds and real estate mortgages. One rentenmark was declared to be equal in value to one prewar gold mark, and the farmers believed it even though it was actually just another inconvertible bank note. The threat of starvation receded as farmers began to ship food to the cities again. Schacht also insisted that the discounting of Treasury bills be stopped forthwith, and two days later it was stopped.

On November 20 (by a curious coincidence, the day on which Dr. Havenstein died) the mark declined to one billionth of its prewar value against the dollar (that is, in the European system of counting, one-million millionth).



That made the arithmetic simple, and so the mark was stabilized by striking off 12 zeroes: 1,000,000,000,000 paper marks were declared to be equal in value to 1 new rentenmark, and, therefore, notionally to one of the gold marks with which 10 years earlier they had been interchangeable.

The stabilization of the external value of the mark was easily accomplished by the simple but drastic step of making credit unavailable to finance foreign exchange speculation. At that time financial transactions in Germany were settled at the end of the month. Toward the end of November the exchange rate on the free market was 12 billion marks to the dollar, but the official rate was 4⅕ billion marks to the dollar. At the end of the month, when speculators came to the Reichsbank to borrow the marks that they had sold short at 12 billion to the dollar, Dr. Schacht refused to make them available—and so they had to cover, either by using their dollar balances to buy marks from the Reichsbank at 4⅕ billion to the dollar or by making the best deal they could on the free market. This sudden and unexpected demand to buy marks with foreign currencies sent their external value soaring. The steady flow of new credit that was required to support the overleveraged corporate conglomerations that had been acquired by inflation-hedgers like Hugo Stinnes was also cut off, and they promptly collapsed.

Thus the inflation was halted *not* by stopping the presses that were printing bank notes but by a cold-turkey policy of abruptly cutting off the flow of new credit to the government and the market. Once the stabilization took hold, deflation was inevitable because the people and businesses that had survived that long had done so by borrowing to the hilt in the expectation that inflation would wipe out the real burden of their debts. In terms of stable prices the economy was fantastically overindebted, and very few of the successful inflation hedges survived the succeeding deflation. Their collapse caused severe unemployment, but at least the total disaster toward which Germany was headed in 1923 was averted.

During the next few years various attempts were made to tax away a bit of the profits that debtors had realized from the destruction of the German financial system and to restore to creditors a trifle of the purchasing power that they had lost. Nevertheless, for all practical purposes the savings that had been held in the form of intangible financial claims were wiped out.

What it is that gets borrowed and lent

The point of this review of 19th and early 20th century financial history is that our present financial system only makes sense in terms of reasonably stable prices, but its great efficiency makes it very easy to produce a destabilizing and inflationary overexpansion of credit. During the 19th century there existed two conditions that tended to prevent such an inflationary overexpansion of credit. One of them we have already discussed: it was the convertibility of financial instruments into money with intrinsic value. The last remaining vestiges of that were driven from the financial scene by the inflationary proliferation of credit instruments in the mid-1960s; it is unlikely to return unless a wholesale financial smash forces us to start over from the beginning, as the Germans did at the end of 1923, and again in 1948. The other condition, which will be discussed later, could be restored much more easily by simply reversing some of the 20th century trends that have overwhelmed it.

But, what is it that get borrowed and lent, if it is not money? The answer that it is credit instruments is correct, but not very enlightening. At bottom, what the creditor lends—and hopes to get back—is the real purchasing power that he has earned by his productive efforts, but the best that the 20th century financial system can guarantee him is nominal purchasing power. The gap between the two can, if it widens much further, destroy both the financial system and the wealth of its creditors.

Some of the theoretical consequences of recognizing that money no longer exists

One consequence of recognizing that nothing that is properly called money exists any longer is that we can get rid of the proliferation of *M*'s (M-1, M-1⁺, M-2, etc.), which is getting out of hand, and start making some more useful distinctions between the various kinds of credit instruments. The meaningful problem that all the *M*'s are clumsy attempts to solve is that of defining different degrees of liquidity, but attempting to solve it in terms of an obsolete distinction between money on the one hand and credit on the other is not very helpful. When you try to draw a sharp qualitative line across what is in fact a continuous spectrum that is best approached in quantitative terms, you naturally run into a problem about just where to put the line; and it is that artificial problem that has produced the plethora of *M*'s.

Liquidity is the crucial factor, not the money supply

The degree of liquidity that financial instruments possess is vitally important both to the holders of those instruments and to the financial and political authorities. Liquidity is important to the holders of financial instruments because it measures the degrees of ease and convenience with which they can be turned back into ready purchasing power, and the degree of certainty that their holders are justified in feeling about just how much real purchasing power they represent. Thus, the more liquid a financial instrument is, the more likely it is to be spent.

Liquidity is also important to the authorities because prices will remain stable only if the society as a whole spends just about as much as it produces. If its spending rises more rapidly than the output of real goods and services expands, the general price level will rise; and if its spending rises less rapidly, either real output or the general price level or both will have to drop. The likelihood that people will spend the savings that they hold in the form of financial instruments is greatly influenced by the liquidity of those instruments, and thus it is vitally important that the overall liquidity of the financial system be appropriate. If the system is too liquid, people will tend to spend excessively and inflation will be a problem; but if it is insufficiently liquid, the need of some people to spend the savings that they hold in the form of relatively illiquid financial instruments, and of other people to liquidate investments in order to get the wherewithal to repay maturing debts, will cause the market prices of the less liquid instruments to decline. If this process goes far enough, it may cause a liquidity crisis, which is also called a financial panic.

The assets of financial institutions are less liquid, but produce a larger income than their liabilities

Since savers usually want to be able to recapture their purchasing power easily and are willing to forgo some income to maintain liquidity while people and businesses that borrow and invest in productive assets want to be sure of having the purchasing power as long as they need it and are willing to pay some additional interest to get it, one of the functions of financial institutions is to accommodate both of them by accepting relatively liquid but also relatively low-cost deposits as their liabilities, and investing them in less liquid but higher yielding financial assets. As a broad generalization, liquidity and income vary inversely to each other. The earnings of financial institutions arise primarily from the spread between the interest rates that they earn and those that they pay. Those earnings represent the value of the service that they render to savers and to borrowers by assuming the risks involved in holding assets that are less liquid than their liabilities.

The absolute distinction between money and credit should be replaced by an accurate measure of degrees of liquidity

As the financial system evolved it developed a wide variety of financial instruments that by now constitute a broad and continuous spectrum with respect to liquidity and yield. One end of the spectrum is represented by bank notes (in the United States, Federal Reserve notes that are called dollar bills) that are almost completely liquid but that yield no income at all. The other end of the spectrum is represented by the bonds and notes of small businesses that have only a local reputation, or the bonds of obscure municipalities that are traded only by the local bank but that provide a good income that is not taxed by the Federal, state or local government.

The degree of liquidity a financial instrument possesses is not always accurately determinable until you actually try to spend it because it depends to some extent on the surrounding circumstances. For example, a million-dollar Treasury bill is easily spendable in any financial center during business hours, but if you want to buy gasoline at two o'clock in the morning, Federal Reserve notes in small denominations will work better. Nevertheless, the liquidity of the various kinds of financial instruments issued by recognized borrowers lends itself reasonably well to quantitative treatment. I propose that we replace the cumbersome array of *M*'s with the tidier system of a schedule of liquidity values.

There is no such thing as a stable rate of inflation

Once we recognize clearly that all the things that get lent and spent in modern economies are financial instruments, which are promises to repay in exchange for then-current purchasing power, and that there no longer exists any limit to the ability of the financial system to create financial claims corresponding to the limit that was imposed upon the financial systems of the 19th century by the creditors' ability to exchange financial instruments for money that possessed intrinsic value, it is easy to see why inflation has become such an intractable problem. First, most of us are more fond of the purchasing power than we are of the work that is involved in earning it by producing real goods and services. Second, in political democracies the way to get elected to political office is to promise the people more of the unearned purchasing power that can be created by the apparently magical and effortless process of debt formation than your opponent does. Third, social democracy asserts that incomes are deserved as a matter of right whether or not we produce real goods and services; and the only way that incomes can be produced out of thin air, without the effort and bother of producing real goods and services, is through debt formation—at the cost of inflation. Finally, once practical people grasp the implications of all this and decide that inflation is here to stay, they rush to borrow as heavily as they can in order to buy real things whose prices they hope will at least keep up with the inflation. Thus a self-sustaining spiral is generated that has the capacity to continue and to accelerate indefinitely as long as credit remains generally available. Once inflation has become endemic, the *only* sure way to stop it is to limit the creation of new credit to the amount that is likely to be used for real productive investment. ■

ELIMINATING RUNAWAY INFLATION: LESSONS FROM THE GERMAN HYPERINFLATION

The German hyperinflation of 1923 is a classic example of what can happen when the monetary authorities let themselves be guided by false and misleading theories. In this case the fallacious theories included (1) an external shock or balance of payments theory of inflation and exchange rate depreciation, (2) a reverse causation theory of the link between money and prices, (3) the notion that the real money stock rather than the nominal money stock is the appropriate indicator of monetary ease or tightness, (4) the real bills doctrine according to which the money supply should accommodate itself to the needs of trade, and (5) the idea that the central bank can stabilize nominal market interest rates simply by pegging its discount rate at some arbitrary level.

Misleading Theories The authorities adhered to these theories to a ludicrous degree. For example, at the height of the inflation when a postage stamp and a newspaper cost 90 billion marks and 200 billion marks respectively, and when the money supply was expanding at a rate of 1300 percent per month and 30 paper mills were working overtime just to keep the Reichsbank supplied with paper for its banknotes, the authorities were actually insisting that money growth had nothing to do with inflation. On the contrary, they blamed inflation on external nonmonetary factors and declared that money growth was the consequence not the cause of inflation. Like modern government officials who attribute our present inflation to the machinations of the OPEC cartel, they located the source of inflation in the postwar punitive actions of the Allies. More specifically, they traced a chain of causation running from reparations burdens to balance of payments deficits to exchange rate depreciation to rising import prices and thence to general price inflation to rising money demand and finally to the money stock itself. That is, they argued that external shocks operating through the balance of payments caused the inflation, that the resulting rise in prices created a need for more money on the part of business and government to carry on the same level of real transactions, and that it was the duty of the Reichsbank to accommodate this need, a duty which it could accomplish without affecting prices. Far from seeing currency expansion as the source of inflation, they argued that it was the solution to the acute shortage of money caused by skyrocketing prices. In this connection they advanced the peculiar theory that monetary excess could not possibly be the source of German inflation since the real or price-deflated value of the German money stock was smaller than it had been before the inflation started. They failed to realize that excessive nominal money growth itself was responsible for the shrinkage in the real money stock. They did not see that inflationary monetary growth, by generating expectations of future inflation (expectations that constitute the anticipated depreciation cost of holding money) had greatly reduced the demand for money and had stimulated a corresponding rise in velocity. This inflation-induced rise in velocity had caused prices to rise faster than the nominal money stock thus producing the observed shrinkage in the real money stock (see chart on following page). This sequence of events, however, was beyond their comprehension. Hence even though the nominal money stock was several trillion times larger than at the beginning of the inflation, they argued that it was still not large enough because prices had actually risen faster than the money stock. They thought that they could prevent further shrinkage of the real money stock by increasing the nominal money stock. In so doing they succumbed to the fallacy that the policymakers can systematically control real economic variables (e.g., the real money stock) by controlling nominal economic variables (e.g., the nominal money stock).

Real Bills Doctrine Another fallacious theory to which they adhered was the real bills or needs of trade doctrine, which says that money can never be excessive as long as it is issued against bank loans made to finance real transactions in goods and services. What they overlooked was that the demand for loans also depends on the level of prices at which those real transactions are effected. They forgot that rising prices would require an ever-growing volume of loans just to finance the same level of real transactions. Under the real bills criterion these loans

Essays on Inflation
Second Edition, Sept. 1980 by
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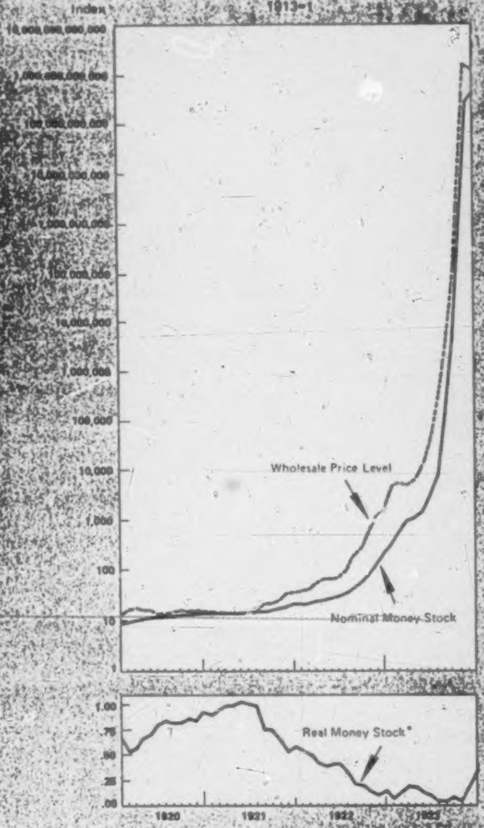
BEHAVIOR OF NOMINAL AND REAL MONEY STOCKS IN THE GERMAN HYPERINFLATION



During the German hyperinflation the nominal money stock exploded while the real money stock, reflecting an inflation-induced flight from cash and a corresponding rise in the circulation velocity of money, declined sharply. The real money stock fell because inflationary nominal monetary growth, by generating expectations of future inflation and thereby raising the anticipated depreciation cost of holding money, reduced the demand for real cash balances and stimulated a corresponding rise in velocity. This expectations-induced rise in velocity caused prices to rise faster than the nominal money stock thus producing the observed fall in the real or price-deflated money stock. Efforts to arrest this fall via faster nominal money growth only served to prolong it. Not until late 1923 when anti-inflationary monetary reform seemed imminent did the real money stock revive.

*Index of the German Money Stock (1913=1) divided by the Index of Wholesale Prices (1913=1).

Source: Frank D. Graham, Exchange, Prices, and Production in Hyperinflation: Germany, 1920-1923 (Princeton University Press, 1930), pp. 105-106.

would be granted and the money stock would therefore expand. In this manner price inflation would generate the very monetary expansion necessary to sustain it and the real bills criterion would not limit the quantity of money in existence. In short, they failed to understand that the real bills criterion cannot distinguish between the price and output components of economic activity and therefore constitutes no bar to the inflationary overissue of money.

Inflationary Discount Rate Policy They also made the mistake of pegging the discount rate at a level of 90 percent, which they regarded as constituting an appropriate degree of monetary tightness at a time when the market rate of interest on bank loans was more than 7300 percent per year. This huge interest differential of course made it extremely profitable for banks to rediscount bills with the Reichsbank and then to loan out the proceeds, thereby producing additional inflationary expansions of the money supply and further upward pressure on interest rates. If the monetary authorities recognized this, however, they said nothing about it.

Monetary Reform Measures But I do not intend to dwell on the hyperinflation per se. Rather I wish to discuss the very successful monetary reform that ended it in a prompt and relatively painless manner—an accomplishment that seems beyond our powers today. Regarding the monetary reform the facts are as follows. On November 15, 1923 the government announced that it intended to get inflation under control. Acting quickly, it did four things.

- First, it transferred responsibility for monetary control from the Reichsbank to Dr. Hjalmar H. Schacht, the newly appointed Commissioner for the National Currency.
- Second, it issued a new currency called the Rentenmark to circulate with the old currency. The Rentenmark was declared to be equal in value to one prewar gold mark or one trillion depreciated paper marks.
- Third, it established a fixed upper limit on the amount of Rentenmarks that could be issued. According to Costantino Bresciani-Turroni, perhaps the leading authority on the hyperinflation episode, this limitation was crucial to the success of the monetary reform.[1]
- Fourth, it directed the Reichsbank to stop the discounting of Treasury bills, which meant in effect that the Reichsbank would issue no more paper money for the government.

The Miracle of the Rentenmark The reform was an instant success. The new currency was in great demand and circulated at its declared gold value. Within weeks the rate of inflation, which had been raging at an annual rate of 300,000 percent, dropped to virtually zero. And this was accomplished at a cost of only 10 percent lost potential output in 1924, the year following the monetary reform.[2]

To get an idea of the magnitude of this accomplishment were it to be attempted today, we can use the late Arthur Okun's rule of thumb calculation (which he derived from evaluating simulations from six econometric models) that the cost in terms of lost output per each 1 percentage point reduction in the rate of inflation is 10 percent of a year's GNP. According to Okun's 10 percent rule, it should have required a 50 percent GNP gap sustained for 600 centuries to eliminate Germany's 300,000 percent inflation rate.[3] In fact, however, the German inflation was virtually eliminated by early 1924 at the cost of only a 10 percent GNP gap.

How did they do it? How did the German authorities manage to eliminate an inflation that was infinitely worse than ours today and yet do it so quickly and painlessly? What recipe for success did they have that our authorities lack today? Most observers correctly note that the key to stopping the inflation was the eradication of inflationary expectations and the restoration of confidence in the German currency. But they offer only the vaguest of explanations as to why that confidence was so easily restored, attributing it either to a yearning of the German national spirit for monetary order and stability or to a naive belief on the part of the public that the new Rentenmark was worth one prewar gold mark simply because it was declared to be worth that much on the face of the note.

The Credibility Hypothesis There is, however, a more plausible explanation that stresses the credibility associated with the government's policy declarations. According to that explanation, when the

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[1] Costantino Bresciani-Turroni, The Economics of Inflation (New York: Augustus Kelley, 1968), pp. 347-348, 402.

[2] Frank D. Graham, Exchange, Prices, and Production in Hyperinflation: Germany, 1920-1923 (Princeton: Princeton University Press, 1930), p. 319.

[3] The computation is Roy Webb's. See his article, "Depression or Price Controls: A Fictitious Dilemma For Anti-Inflation Policy," Federal Reserve Bank of Richmond, Economic Review 66 (May/June 1980), p. 4.

German officials announced in November 1923 their intention to halt inflation, the public was fully convinced and accordingly swiftly revised downward its expectations of future inflation. People believed the government not only because it had placed the responsibility for stabilization in new hands but also because prior to the monetary reform it had taken decisive steps to reduce the budgetary deficits that were an immediate cause of inflationary money growth.[4] Consisting of drastic cuts in expenditures (particularly welfare relief to striking workers) and the levying of taxes in real (i.e., gold) rather than nominal terms, these measures were widely regarded as an essential prerequisite to monetary stabilization and a clear indication of the government's intention to end inflation. People also believed the government because it had not tried to mislead the public during the preceding hyperinflation. True, the officials had misunderstood the cause of the hyperinflation. But they at least had not lied to the public about the policy rule they were following at the time. On the contrary, throughout the inflationary episode the authorities candidly acknowledged that their main policy objective was to accommodate inflation with sufficient monetary growth to overcome inflation-induced shortages of money and to stabilize the real value of the money stock. In this connection Reichsbank president Rudolf Havenstein even boasted of the installation of new high-speed currency printing presses that would enable money growth to keep up with skyrocketing prices.

Because the authorities had instituted budget reforms compatible with monetary stability and because they had not lied to the public about the policy rule in effect during the preceding hyperinflation, there was ample reason for the public to believe the authorities' announced intention to change the policy rule and halt inflationary money growth. Consequently, inflationary expectations were swiftly revised to zero when the halt was announced, thereby allowing the speedy removal of inflation without large increases in lost ouput. Evidently, policy credibility was essential to the reversal of inflationary expectations and the resulting rapid termination of inflation.

Lessons of the Monetary Reform There are at least three lessons to be learned from the monetary reform that ended the German hyperinflation. First, the task of subduing inflation is easier

- if the policymakers have established a record of credibility,
- if they accurately convey their intentions to the public, and
- if they convince the public of their resolve to stop inflation.

Unfortunately, these ingredients have been sadly lacking in many countries in recent years where anti-inflation rhetoric has been accompanied by steady and persistent increases in the basic trend rate of inflation.

Credible Policy Strategies A second lesson to be learned from the German stabilization episode is that a credible anti-inflation policy must focus on a single objective, namely the elimination of inflation.[5] A shifting-targets policy that focuses now on inflation, now on unemployment, now on interest rates or the foreign exchange value of the dollar or still some other objective will be largely ineffective in fighting inflation. The public, having observed the past tendency of the authorities to shift from one policy objective to another, will expect monetary restraint to be abandoned upon the first signs of economic slack as monetary policy shifts from fighting inflation to fighting unemployment. Knowing that monetary restraint will be temporary, wage and price setters will have no incentive to accept lower rates of wage and price increases when such restraint occurs. As a result, the inflation rate will respond but little to the short-lived efforts to reduce it.

The preceding should not be taken to imply that inflation is inherently resistant to all policy strategies. On the contrary, were the government to drop its shifting-targets policy strategy for one devoted solely to eliminating inflation, the inflation rate might subside rapidly once the public was convinced that a true anti-inflation policy was in force. Confronted with a new policy environment, economic agents would have an incentive to alter their wage- and price-setting behavior in a manner consistent with rapid adjustment to lower rates of inflation.

The third lesson is that we should be wary of pessimistic conclusions that inflation can only be removed at the cost of a protracted and painful recession. Those conclusions often are derived from econometric models estimated for the period when the government's shifting-targets policy was in effect. These models usually assume that economic agents will not change their wage- and price-setting strategies when the policy environment changes. This assumption is questionable. For as mentioned above, if the focus of monetary policy were to change from a shifting-targets strategy to one of permanently eliminating inflation, the context in which wage and price decisions are made would be drastically altered. Responding to the new policy environment, people would adjust their expectational and price-setting behavior accordingly. Consequently, inflation would be less intractable and costly to subdue than in the past and the inflation rate could be brought down more swiftly and painlessly than indicated by the econometric models. The trick of course would be in convincing the public that the policy environment had indeed changed. But this could be done if the policymakers were to announce anti-inflation targets and then demonstrate that they were meeting those targets. Given a successful track record of meeting stated anti-inflation targets, policy credibility would be restored thus making it easier to get inflation under control.

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[4] On this point see Ragnar Nurkse's comments in The Course and Control of Inflation (Geneva: League of Nations, 1946), pp. 22-23, 68-73. Nurkse stresses the contribution made by the fiscal reforms to the success of the stabilization of the mark. In particular, he notes that, since budget deficits were largely financed by inflationary money growth, decisive steps to reduce those deficits and bring the budget under control improved the prospects for monetary stabilization and thereby lowered inflationary expectations.

[5] What follows draws heavily from Webb, op. cit., p. 5.

Conclusion The preceding has enumerated three lessons taught by the stabilization episode that ended the German hyperinflation. Whether modern policymakers will ever consistently apply these lessons remains to be seen. Certainly the post-World War II policy record in many countries is hardly encouraging on this score, indicating as it does a tendency for the lessons to be more often forgotten than remembered. Over the past year, however, there are signs that the authorities both at home and abroad may have started to apply the lessons and that they may have abandoned their old shifting-targets policy of responding to the most pressing short-run concerns for a new longer run policy of eliminating inflation. The current recession, bringing pressures on the policymakers to shift from fighting inflation to fighting unemployment, should reveal whether this is in fact the case. So should the ensuing recovery when the central bank undoubtedly will be called upon to accelerate money growth to keep interest rates from rising. If the authorities can resist these pressures and stick to their longer term policy of eliminating inflation they will have shown that they have indeed learned the lessons of the German hyperinflation.

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Money is no good any more because there is no limit to the amount that can be made, and no standard to maintain its value. We do not yet have a runaway inflation only because this is a central bankers' inflation–a wise man's inflation of which the wise men are losing control. Yet the monstrous growth of bad money will at some point produce the crash that has followed every great inflation. As this is the gre[illegible] world inflations it is likely to be followed by the greatest of world crashes.

The inflation is now in its later stages, but it will not end just yet, because the people of the world are still more afraid of the pains of the crash than they are of the pain of inflation continuing.

When it does end every democratic government of the world will be under attack from authoritarian claimants to power, whether Colonels or communists. Dictatorship will not turn bad money into good; nothing that has to be done cannot be done by democracy. Yet inflation naturally breeds dictatorships, as it created both Napoleon and Hitler, both by making people suppose that democratic governments do not work, and by making them think that detailed intervention by an all powerful state is the only cure for the detailed symptoms of which inflation is the cause.

What is needed is a valid world currency, a standard and store of value and that currency will prove to be gold, a metal governments cannot make. Good money is the necessary foundation for good government; the only good government is free government.

Flip to Back Cover

William Rees-Mogg has been Editor of *The Times* since 1967. He was born in 1928 and educated at Balliol College, Oxford where he became President of the Oxford Union in 1951. He worked on the *Financial Times* as Chief Leader Writer and Assistant Editor from 1952 to 1960. From 1960 to 1967 he worked on the *Sunday Times* as City Editor, Political and Economic Editor and Deputy Editor.

The Reigning Erro

The Crisis of World Inflation

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HAMISH HAMILTON
LONDON

SBN 241 89155 8
Printed in England

Chapter 4
The Case for Gold from the book The Reigning Error, the crisis of World Inflation - William Rees - Mogg
Harmish Hamilton London, 1974

CHAPTER FOUR

THE CASE FOR GOLD

> The individualistic Capitalism of today . . . presumes a stable measuring rod of value and cannot be efficient – perhaps cannot survive – without one.
>
> John Maynard Keynes
> *Tract on Monetary Reform,* 1923

The argument that convinced me of the case for gold was that it worked. We are in the middle of a world inflation which is described by the Organisation for Economic Co-operation and Development as 'unprecedented' for all its members and as 'intolerable' for Japan, which at the beginning of 1974 had an inflation rate of 24.5 per cent. Since 1968 the link with gold in the world monetary system – the convertibility of the dollar into gold – has been broken in fact, and since 1971 has been broken completely. That has been the period in which the world inflation has accelerated from unsatisfactory but tolerable to unprecedented and intolerable levels.

Yet it is not to the pre-1968 Bretton Woods compromise that one would look for the basic proof of the relationship between a gold standard and price stability. There are much longer runs of historic experience to be examined, under conditions much closer to those of a perfect gold standard.

First of all one should examine British experience. From the restoration of King Charles II in 1660 down to the outbreak of the first world war Britain operated on an unqualified gold standard. There was a debt repudiation in the reign of Charles II, which need not be taken into account, and suspension of convertibility by the Bank of England from 1797 to 1821, which was made necessary by the war with France. However, from 1661 to 1913, with the exception of the Napoleonic period, there was full internal and external convertibility into gold, so complete that all other forms of money can be regarded simply

Prices since 1661 (1661 = 100)*

Figures for each decade are along a horizontal line: e.g. that for 1667 = 88, for 1944 = 195.

	0	1	2	3	4	5	6	7	8	9
166–		100	103	101	96	96	92	88	88	84
167–	85	84	81	80	86	92	88	81	82	87
168–	85	82	82	80	81	83	84	74	74	73
169–	75	76	75	78	87	87	89	90	95	98
170–	85	74	73	70	73	66	75	65	68	79
171–	90	100	75	72	76	77	73	70	69	72
172–	75	74	68	66	70	72	75	71	73	77
173–	70	65	66	63	65	66	64	69	67	66
174–	74	80	73	70	62	63	69	67	70	71
175–	70	67	69	67	67	68	68	81	78	74
176–	73	70	70	74	75	78	79	81	80	73
177–	74	79	87	88	86	84	84	80	87	82
178–	81	85	86	95	93	89	88	87	90	87
179–	92	90	90	95	101	109	114	110	110	118
180–	157	169	129	115	119	138	136	138	151	157
181–	153	152	175	180	155	141	127	140	144	128
182–	115	105	101	104	106	115	102	102	97	95
183–	95	97	95	93	97	97	107	102	103	113
184–	111	105	96	91	94	95	95	100	87	82
185–	82	79	82	97	108	108	108	110	96	100
186–	104	100	104	105	103	102	104	102	100	93
187–	95	100	111	110	105	102	100	95	88	85
188–	89	86	88	88	82	76	72	70	73	73
189–	76	75	71	71	64	62	63	64	68	73
190–	79	75	75	75	72	75	81	84	76	80
191–	84	86	91	91	91	116	146	193	207	222
192–	270	167	141	139	150	146	136	131	129	124
193–	104	89	86	35	103	103	106	110	113	113
194–	152	205	195	177	195	191	191	205	219	227
195–	234	251	269	273	276	287	301	312	319	319
196–	322	333	347	354	365	379	396	404	425	446
197–	474	513	545	595						

**Linked index. Main sources: Mitchell and Deane, Abstracts of British Historical Statistics, and Department of Employment, British Labour Statistics Historical Abstract 1886-1968.*

Basic series: Schrumpeter-Gilboy price index 1661-1697 (1697 = 100) and 1696-1823 (1701 = 100); Rousseaux price indexes 1800-1923 (1865 to 1885 = 100); Sauerbeck Statist price indexes 1846-1938 (1867 to 1877 = 100); DE index of the internal purchasing power of the pound 1914-1968 (1963 = 100).

Series rebased on 1661 = 100 using the multipliers: 1697 = 100; 0.9174: 1701 = 100, 0.7399; 1865-1885 = 100, 0.8679; 1867-1877 = 100, 1.0761; 1963 = 100, 3.5417.

Source: *The Economist*, July 13, 1974 as convenient transferable receipts for gold. Gold was money and money was gold.

During the pre-Napoleonic period from 1661 to 1796, according to a most valuable table of prices compiled by the *Economist*, the low point of prices occurred in 1743, at an index figure of 62 against 100 for 1661. The high was 114 in 1796, shortly before the suspension of convertibility. In the post-Napoleonic period, from 1822 to 1913, leaving out 1797 and 1821 when there was not convertibility for the whole year, the low was again 62 in 1895, and the high was 115 in 1825, again close to the non-convertible period. The high of the wartime inflation of the Napoleonic War was 180.

There must be some reservation about price indices compiled over such a long period, but the high degree of stability they show is not illusory. Prices in Britain were very stable for the two hundred and fifty years after the Restoration, with the exception of the Napoleonic period. It is quite plausible that prices were about 10 per cent lower in 1913 than in 1661; there is nothing in what we know of the economic circumstances of those two periods to contradict it. Prices were very low in the middle 1740s and the middle 1890s.

Yet what these figures suggest is that the British price system in this period was not only stable but had a strong tendency to return to an equilibrium point. In fact the choice of 1661 as the base year slightly obscures this pattern, for 1661 was still a year of some political excitement and therefore of relatively high prices. If one takes the first year of each decade from 1670 on, one has a better picture of the degree of stability (again excluding the non-convertible years): 85, 85, 75, 85, 90, 75, 70, 74, 70, 73, 81, 92, 95, 111, 82, 104, 95, 89, 76, 79, 84. Of these twenty-one years, twelve, including the first five and the last four, fall into the range from 75 to 90; four fall below 75; five rise above 90. It seems clear from this that there was a equilibrium range towards which prices tended to return.

This long period of history cannot be dismissed as uneventful. Though it excludes the Napoleonic War, it includes Marlborough's wars, it includes one successful and three unsuccessful attempts to change the British regime, it includes the industrial revolution, it includes the impacts of the American War of Independence and the American Civil War, it includes the creation of the British Empire, virtually the whole of it, it even includes the creation of the trade unions, and it includes the development of modern parliamentary democracy on mass suffrage. Nor was it a period of long-term economic depression or of failure to increase wages. Industrially it was a most creative period in British history and real wages rose firmly, though not without interruption. Yet during the whole of this period the British price system beat like a steady pulse, affected by economic and political events but with a strong natural tendency to return to normality. One only has to contrast that period of centuries with what now happens to prices in a year or so, to see how great a benefit we have lost, whatever the reasons for losing it. Our price indexes now rise by nearly 20 per cent in a year, compared to the 10 per cent decline in the 252 years from 1661 to 1913, or to the one per cent decline in the 240 years from 1670 to 1910.

One should not, however, look at British experience alone. In the monetary history of the United States we have shorter runs and more monetary experimentation. From 1879 to 1914 the dollar was convertible into gold at a fixed ratio specified by law and maintained in practice. Chart 62 of Friedman and Schwartz, *A Monetary History of the United States*, shows the high degree of stability of wholesale prices in that period, fully comparable to the stability in Britain.

The contrast between earlier periods and our own is the more striking because our weapons of economic analysis are now so much more powerful than theirs were. Apart from developments of economic theory, some of which may of course be mistaken, we have a capacity to collect statistics, and process them through computers, which gives us a vastly greater knowledge of the progress of our economic system. Yet the government of King Charles II (whom Burke rather harshly described as 'dissolute, false, venal, and destitute of any positive good quality whatsoever, except a pleasant temper, and the manners of a gentleman'), itself often bankrupt, certainly corrupt, with no coherent economic theory, a century before Adam Smith, using quill pens, was able after the Restoration to start a quarter-millennium of price stability, while we are despairingly coming to believe that inflation is an unavoidable curse of mankind. If medicine had progressed in the same way as economics, London would have been quite free of plague in 1665, but now plague would be endemic, and world-wide.

There can be no real doubt that it was the gold standard which produced this extraordinary price stability. The correlation is perfect; there is no period of history, except for the recognisable gold inflations in which new mined or plundered gold was too rapidly increasing the gold stock, in which successfully maintained gold standards have not been accompanied by long-term price stability, either nationally or internationally. Even the gold inflations are mild and long-term, not explosions of inflation. The record of currencies not in any way linked to gold is one of almost consistent inflation, often explosive. All gold standard money has been good money; all non-gold money, if totally divorced from a metallic standard, has proved to be bad money. Why then did the pound not suffer more rapid inflation between 1931 and 1971? Because for most of that period the pound was fixed to the dollar and the dollar was convertible into gold. We have not had a satisfactory gold standard since August 1914, but with brief intervals we have had some continuing gold discipline down to 1971, despite the changes and experiments of the intervening period.

The question that has to be considered is how gold achieves these, to us, astonishing results. Gold is not magic. Because of its long association with money, gold does have a symbolic hold upon the human imagination. This can make it politically more powerful, or it can repel people. But as *Little Arthur's History of England* puts it, 'you must know that gold is only useful to help people in exchanging one useful thing for another'.

The answer is in essence quite simple. Gold is indeed the conclusive proof of the monetarist case, though not all monetarists believe in gold. Professor Friedman, the leading monetarist, believes that the ideal policy would be to ensure that the money stock was constant but gradually increasing. A money stock which is gold, or is limited by relationship to a gold base, naturally fulfils these conditions. The gold stock will neither diminish nor increase as the result of human action, except through industrial use of new mining, and those will always form only a small proportion of the existing world stock of gold.

Obviously it is possible for the authorities of an individual country to adopt monetary policies which follow the Friedman doctrine, and some monetarists argue that gold is an unnecessary complication because you can achieve the right policies without gold. Such policies do tend to correct inflation, but they suffer from two important disadvantages.

The first is that monetary policy does not have the same effect on expectation that gold does. For instance, during the French inflation, the actual plates for printing assignats were publicly destroyed in order to convince the public that new assignats were not going to be created. Even that did not work. A modern government makes decisions about monetary policy which only a tiny minority understand, and not all of those believe will be carried through. Therefore a strict money supply policy has a long time-lag before it can be seen to be a consistent part of government policy. The gold commitment is not itself unchangeable, but it is seen immediately and its nature is generally understood. A government which goes on gold makes a statement to its people that in future the nation will have to earn real money, that the government and individuals will both have to pay their way in the world in the hardest of hard currencies, that the money supply will be limited.

The second advantage of gold is that it is the only way to secure sound monetary policies for the whole world at once. Professor Friedman is not going to be able to persuade all governments, or even all major governments, to control their money in the same way. Gold not only automatically provides the ideal money supply policy – or something close to it – but also provides it as a world money supply. This is all the more important as it is now a world inflation which we have to bring under control.

Supposing one were trying to set up a world money system to provide for economic stability, including price stability – and there is no stability without price stability – its characteristics would be that the money supply should be constant, that it should gradually increase, that it should not be open to individual governments to add to it, that it should not be open to unregulated credit markets, such as the Euro-currency market, to add to it, that it should be widely acceptable. Perhaps one would add that this new system must be objective rather than subjective, so that it would not be open to political pressure; perhaps also that it should be permanent, that the form of the money itself should be immutable. One might, in working out the ideal terms for a world currency system designed to bring to an end an age of inflation, reach such conclusions as these. One would have invented the gold standard.

Gold has worked historically and meets, in a way no paper system does, the theoretical requirements of a stable world monetary system. There are difficulties to be discussed, but they will be taken later. Yet it has two further advantages, both very important.

The first is that it is concrete and unchangeable, not abstract and changeable. All other currency systems, except other metallic ones, depend on the authority of the issuing government. That authority is both abstract and changeable. All human organisations perish over time. The Roman Catholic Church is as old as the Christian era, save for some fifty years; that is a religious organisation, against which the gates of Hell shall not prevail, but secular organisations seldom have that length of life. Democratic governments change at elections, dictatorships change by intrigue or force. However powerful the government, its currency is only a promise to pay on behalf of a temporary authority, a promise to pay limited by a temporary capacity to pay. There is no authority now which will pay on the promise of Alexander, or Julius Caesar, Louis XIV, Peter the Great, Napoleon or Hitler; they were powerful men in their time but no bank now will cash their cheques. Yet take a gold ingot which was once in their treasuries and you can obtain value for it anywhere in the world. The permanence and universality of gold give it an authority as money which no other money has.

There is also an advantage that may prove in the end to be the crucial one. I argued earlier that changes in the nominal money supply control prices, but that changes in the real money supply control the level of economic activity. This must logically be so. If the supply of money doubles and prices double, then the expansive effect on demand of the increase in money is precisely counteracted by the contracting effect of the increase in prices. If, on the other hand, the money supply doubles, but prices increase by less than that, then there will be spare money to be spent, and that will call for further business activity.

The evidence from France in the 1790s, from Germany in the early 1920s and from the world inflation now, is that inflation goes through two major stages (in fact the phases of inflation are more complicated than this, but the two stages represent the vital distinction). In phase one, the money supply increases faster than prices; this is possible because there is still some slack in the economy, inflationary expectation is still weak, governments are as yet unafraid of increasing the money supply. In these circumstances business activity improves because the increase in the nominal money supply is also an increase in the real money supply.

In the second phase prices tend to increase faster than the money supply. We have seen that this presents governments with a dilemma which is actually insoluble in orthodox neo-Keynesian terms. If the government pursues a strict monetary policy then the real money supply is very sharply deflated, and this produces a slump. If the money supply is further inflated, then the inflationary cycle goes a stage further. In the final stages of an inflation governments may actually be unable to keep up. So-called stagflation and slumpflation are the inevitable reflection of the progressive divergence between a rising nominal and a falling real supply of money.

In this situation gold is not only the best way of dealing with the inflation; it is also the best way of dealing with the slump. It is known that the real world stock of gold cannot be artificially increased; that is a powerful corrective to inflationary expectation. It is also known that the real world stock of gold cannot be artificially reduced; that is a powerful corrective to deflationary expectation. Gold is often thought of as an inherently deflationary monetary system, because it is so easy to see how it limits inflation by limiting the money supply. In fact gold does not naturally lead to deflation; it was certainly not gold which caused the great slump, but a mismanagement of the United States money supply not consequent on gold or gold movements. The natural tendency of gold is to prevent rapid alteration of the money stock, and therefore to inhibit inflation and deflation alike.

If, in the immediate future, we have to face a world slump or severe depressions in individual countries, it will be because the monetary authorities are trying to restrain inflation while prices are still rising. The only result can be a sharp contraction of the real money supply. The right way to correct this tendency to world slump, which is itself inherent in a world inflation, is to change to a money supply which is known for sure to be constant.

This can be shown by the behaviour of interest rates. The record of stable long-term interest rates under the gold standard is comparable to the stability of prices. In the 157 fully convertible years between 1731 and 1913, British interest rates on undated government stocks stayed with marked consistency in the range between 3 and 4 per cent. In twenty of those years interest rates were below 3 per cent throughout the year; in eleven of those years interest rates were at 4 per cent or above; the highest recorded rate was 5.7 per cent in 1782. In 136 of the years long-term interest rates were between 3 and 4 per cent for part or all of the year, usually for all of it. The comparable stock now yields nearly 16 per cent (August 1974).

If we suppose a government which decided to pursue a policy of close restriction of the money supply, what would be the effect on interest rates? They would unquestionably rise. The market would expect a liquidity crisis, short-term interest rates would rise sharply, long-term interest rates would rise sympathetically and would only start to fall when it was seen that any forced sales of stocks had been completed, and that the rate of inflation had actually started to fall.

What would happen to interest rates if instead of restricting the supply of money, without changing the character of the money, the same government followed the same policies, but with the addition of a return or an intention to return to the gold standard? Unquestionably, long-term interest rates would fall. At present many people are content to hold gold in the form of bullion, which cannot yield interest. A government-guaranteed gold stock with interest, if issued or converted by a government with a good record for avoiding default, ought to yield something around the historic 3 to 4 per cent rate for undated British government securities.

No doubt it would take some time for confidence to develop; yields on British undated stocks would not fall immediately from over 15 to under 5 per cent, but they would fall, and given the backing of balanced financial policies they would go on falling to something around the traditional rate. Even now the United States could probably float a gold loan at the traditional rates, and could perhaps borrow long-term on a gold pledge at 3 per cent.

Interest rates on bonds redeemable in gold tend to approximate to interest rates on farm land. Land and gold are indeed closely linked; they are two permanent economic factors, both of limited availability. Land is less convenient than bullion in so far as it is not portable, and is therefore in currency terms not liquid. If, however, bullion is regarded as equivalent to liquid land, and receives no interest, gold loans and land receive interest in compensation for the reduction of liquidity involved in their ownership. Land has traditionally been dealt in at 20 to 25 years purchase of the gross rent, equivalent to a 3 to 4 per cent rate of interest, after allowing for the expenses of the landowner. Inflation, which has pushed up paper interest rates, has conversely pushed down the interest on land, as a real asset.

Thus the view that it comes to the same thing to have a strict monetary policy or a gold policy falls down on the interest rate argument. A strict monetary policy does not of itself tend to equilibrium or to low interest rates; it tends to high interest rates and to slump. It is preferable to further inflation through easy money, but that is all one can say. Gold tends to lower interest rates, and to re-establish equilibrium.

Of course, if this fall in nominal interest rates were also a fall in real interest rates it might be highly inflationary. It is not. In Britain the current rate of inflation is 19 per cent or thereabouts. The real rate of interest on undated government securities (now 16 per cent) is therefore approximately minus 3 per cent per annum, even for those who enjoy it tax free. In other words the government charge 3 per cent per annum for the privilege of lending them money. A 4 per cent rate of interest on a gold standard undated government security would be 4 per cent nominal and 4 per cent real. Nominal interest rates would drop by 12 per cent, but real interest rates, in terms of constant money, would rise by 7 per cent, from 3 per cent negative to 4 per cent positive.

This change cannot be achieved by any manipulation of paper money whatsoever, because the expectation of gold cannot be won by paper money. It is obvious that such a change is beneficial to the lender. He is now being robbed of money by the depreciation of the currency, and there is no way in which he can protect himself. He would be restored to a position in which he would be modestly but genuinely paid for the use of his money, and would be able to get it back at its full gold value. The whole problem of pensions would become easier to solve and there would obviously be a strong encouragement to save. Nobody really knows what the relationship of actual saving to the true rewards of saving is, but what influence stability has on saving must be favourable.

The borrower would seem at first sight to lose by the bargain. At present he borrows bad money at a high rate, expecting to repay it in worse money. Then he would borrow good money, admittedly at a lower rate, and would have to repay it in equally good money. He would borrow so many ounces of gold and be obliged to repay an equal number of ounces of gold.

Yet different borrowers would be affected in different ways. The speculator would suffer because there would be no automatic deterioration of money to raise the prices of the commodity or property he purchases with the loan. The trader and the industrialist are, however, less concerned than the speculator with long-term changes in capital value, and more concerned with the proportion of borrowing costs to gross margins of profit. They are also concerned with keeping the interest penalty for an error of judgement as low as possible.

If a manufacturer borrows from his bank at 15 per cent, he has to be able to see a profit on top of that 15 per cent inside the period in which he is planning to use the money. Even in an inflationary boom that may be difficult. In an inflationary slump it may be impossible. Over three years at compound interest of 15 per cent, £100 borrowed becomes more than £150; in five years more than £200. A businessman can therefore run into really serious difficulties in relatively short periods if he is borrowing at these rates of interest. At 5 per cent compound interest, £100 takes nine years to reach £150, a period which gives a businessman time to correct an error, and makes a minor misjudgement of the market relatively inexpensive.

Inflation in general makes business more difficult to transact, because it makes it more difficult to predict. High nominal interest rates accentuate the penalty on business errors. Small but stable profits encourage business expansion more than higher but uncertain profit expectations.

In practice, therefore, businessmen engaged in making or selling tend to think in terms of nominal rather than of real rates of interest. They will be more deterrred by high nominal, but negative real rates of interest, than by low nominal rates which are also positive in real terms. Speculators must think differently, but a switch of willingness to use money from speculation to production is obviously desirable in itself.

This point is of great importance. The characteristic of a gold system is that it has an automatic tendency to revert towards price and interest rate equilibrium. This discipline is exercised through a constant world money supply; for the individual country it is exercised through the penalty of losing gold or having to borrow in circumstances of trade deficit. A gold standard therefore also naturally tends towards equilibrium of trade, and universality of prices.

In particular, gold is ideally suited to the final stages of inflation, because it at the same time counteracts four destructive forces: the rise in prices, the fall in the real money supply, the rise of interest rates (at the peak of the German inflation interest rates were paid of 200 per cent a month) and the non-acceptability of money. In these circumstances a gold policy is the most favourable policy for restoring a higher level of economic activity and raising employment. In slumpflation gold is specific to counteract not only the inflation but also the slump.

What then are the objections? There are important technical objections which have to be considered, but there are also basic philosophical and economic objections. For Britain it means abandoning the overriding post-war priority to full employment. That does not mean abandoning the objective of full employment; indeed in present circumstances a gold standard policy could well become the only way to maintain high levels of employment.

It was clearly stated in the 1944 White Paper on Employment Policy: 'Action taken by the Government to maintain expenditure will be fruitless unless wages and prices are kept reasonably stable. This is of vital importance to any employment policy, and must be clearly understood by the public.' In the *Economic Journal*, 1943, Keynes took the same point: 'Some people argue that a capitalist country is doomed to failure because it will be found impossible in conditions of full employment to prevent a progressive increase in wages. . . . Whether this is so remains to be seen. The more conscious we are of this problem, the likelier we shall be to surmount it.' The weakness of the position can be judged from the uncharacteristic feebleness of Keynes' last sentence. In fact therefore, on Keynes' or the White Paper's assumptions, the full employment standard has already been totally undermined by the failure to keep wages and prices reasonably stable.

What has to change is the degree of priority. We have tried to operate the economy with a constant high level of employment as an absolute, around which everything else – prices, money supply, external trade – was supposed to vary. This was made to work until the late 1960s by a compromise between full employment policies and a commitment not to devalue in terms of the dollar, while the dollar was still linked to gold. This compromise resulted in the stop-go policies of this period, which themselves tended to prevent runaway inflation. In itself, however, the full employment standard has no tendency to bring the economy into equilibrium; on the contrary, while full employment can flow from the successful management of an equilibrium system, a full employment standard system as such is inherently inflationary and therefore self-destructive.

We do in any case have to abandon the economic model of the 1944 White Paper, unless there is a return to the conditions of prolonged world slump which produced it. The 1944 system uses government expenditure to regulate the economy; the expenditure is not covered by taxation or genuine borrowing out of savings and therefore increases the money supply, and increases economic activity through the Keynesian multiplier. In deflationary circumstances this works, because an increase in the nominal money supply will increase the real money supply; it continues to work in conditions of stable or gently rising prices; in rapid inflation it ceases to work, because by then the government, while continuing to control the nominal money supply, has lost control of the real money supply.

In American terms the objection to gold has been put with elegant brevity by Professor Friedman. Under a gold system the stock of money of an individual country becomes a dependent, not an independent variable, since under a gold system the stock of money responds to changes in the balance of payments. This is why monetarists often reject gold. They see money as the control system of the economy; they want to keep it under their control. Under a gold system the stock of money, allowing for borrowing and a certain amount of management, is dependent on external trade. If there is an overall external deficit the stock of money contracts – or has to be contracted in order to restore or maintain international confidence – and prices and employment tend to fall; if there is an overall surplus the stock of money expands and prices, employment and wages tend to rise.

There is a psychological resistance to accepting the idea of gold. It is alarming to human nature, this icy shock of facing the absolute, though most people are perfectly happy to be flown across the Atlantic by an automatic rather than a human pilot. The absolute is itself not uniformly favourable; it is much more comfortable for a strong economic country to attach itself to an automatic self-equilibriating system than for a weak one.

Yet when one compares the systems one sees that the objective gold system provides real advantages over the subjective paper one. Gold provides a constant or slowly increasing world stock of money; paper does not. Gold makes world inflation impossible; paper makes world inflation inevitable. Gold forces countries to face the realities of their economic position, and at an early stage; paper allows countries to delude themselves about their position until they have stocked up trouble. Gold leaves little room for economic manipulation for electoral purposes; paper tempts governments to buy votes by inflation. Gold provides stable and continuous objectives for business; paper produces wild fluctuations in business conditions.

Dr Norbert Weiner's classical work on *Cybernetics*, the theory of communication systems, first established the characteristics of effective and ineffective control systems. A gold system is a self-equilibriating system operating on a constant world money supply, in the same way that a self-equilibriating navigational system can operate on magnetic North as its stable measuring rod. Managed money systems all have the characteristic of extreme oscillations of over-correction which mark the defective cybernetic system, and because they lack a stable point of reference, they are logically defective; you cannot read a map if North is mobile. One might think that no one dependent on the British money supply in the last decade would now prefer subjective judgement to automatic objectivity.

What is it one is putting first if one opts for gold? It is the equilibrium of the whole world monetary system. That in itself does not solve the economic problems of the world, or the economic problems of individual nations, but it does go as far as money can go to create conditions in which nations can try to solve their own problems according to their own political and economic systems. Certainly it does not confront them with the problems of wild instability of world money which we now face. Over any long period of time this instability is likely to produce higher average rates of unemployment, as well as more distress, than gold did or would do.

Yet this instability is inevitable if the world depends, as it now does, on multiple, separately managed national currencies. We now have no world currency – unless S.D.RS. are called such – but exchange dubious national promissory notes which are all more or less over-issued. These promissory notes are not even all regulated by the nation concerned; on top of the national credit inflations we have the credit inflation of the Euro-currency markets. Nothing could be more certain than that in such a system most nations will somewhat inflate, and some nations and the Euro-currency markets will grossly inflate, the issue of these untrustworthy tickets; that could be predicted, it has happened and it is happening. A world money supply which is the sum of inflated national money supplies can itself only produce world inflation, with steep swings into slump when inflated prices outstrip inflated issues of currency. After two and a half thousand years we have produced the most divided, the least controlled, the most untrustworthy and the most dangerous currency system the world as a whole has known.

This has all been done with the sincere intention of increasing the welfare of mankind through economic growth. There is of course a genuine question about the optimum rate of increase in the money supply to finance the optimum rate of economic growth. There is also a question about the optimum rate of economic growth, and perhaps that needs to be looked at first.

In the post-war period a purely statistical approach to economic growth has often been followed. That was dangerously misleading, partly because the statistics were often wrong (Communist statistics were often mere propaganda, or the summary of false statements, made for self-interested reasons). Even when the statistics were right they over-emphasised rapid industrial growth relative to the general development of the society. As a result Japan appeared to be much the most successful economy of the world, at a time when lop-sided industrial growth at an astonishingly rapid rate was causing almost every type of consequential problem of social disorientation, big city slums, pollution and so on. The most succesful nation by the standard of the 1960s was rapidly destroying her own civilisation. Most observers are now agreed that a slower but better balanced economic development, with more attention to social development, would have served Japan better. Inordinate statistical growth was good for political speeches, but not good for people.

Balanced growth and a conservationist attitude towards nature and natural resources are almost certainly better suited than maximum growth to the real welfare of human beings. Balanced investment is more productive than Stalinist investment drives. Unlimited paper credit tends to finance and encourage both speculation and in favourable conditions exactly the kind of exorbitant growth that has now rightly come under suspicion.

The ideal would probably therefore be that the world's money stock should grow by about 3½ per cent per annum, a reasonable approximation to the world's annual potential for sound development. The gold stock will not increase at that rate. New mined gold in South Africa and the Soviet Union, less industrial use, might at best increase the gold stock by something of the order of 1 per cent, but the rate cannot be calculated, as it depends on facts we do not know about Russian production, and on the future price of gold, which we cannot foretell.

However, one should not think of the gold system, however established, as a system in which credit has no part. A gold standard is a system in which gold is the base of the credit pyramid of the world, but the pyramid is not itself built of blocks of bullion. On top of the gold base one has therefore to allow for changes in the quantity of credit; there is no question but that the credit pyramid will tend to expand faster than the gold base, but will expand only at a limited rate. The fact that the credit has to refer back to the gold base will constantly act to prevent an inflationary credit explosion.

The reason why credit grows faster than its money base is probably this. Since the development of modern banking began in the seventeenth century there has been a steady, though not uniform, increase in the complexity of the credit structure, and this increase in complexity has multiplied the effectiveness of credit. This complexification of banking will, except in circumstances of panic, continue, and may make good the shortfall of new mined gold against the desired growth of world business.

Nor should the gold system be regarded as one which is so purely automatic that it needs no management. Much of the benefit of the gold system came from the fact that central banks operated by its rules, and acted early as a result, before trends had become too strongly established. The Bretton Woods structure, with the International Monetary Fund and the central banks working together, is well suited to the organisation of a gold system. Indeed, so long as the dollar remained convertible, Bretton Woods was of course a gold and convertible currencies system, and from the American side was designed as such. The International Monetary Fund ought itself to remain the central bank for central banks, with its own stock of gold, and ought to be responsible for the favourable operation of the system.

The objection is often raised that there is not enough gold in the world, or that Britain does not have enough gold. The question of the amount of gold that is needed is partly a question of price, and partly of confidence. When the price of gold was frozen at $35 an ounce, over a period in which the dollar exchange system had financed a great increase in other prices, that certainly produced a situation in which there was too little gold to provide the ultimate reserve liquidity. Historically there has been no fixed ratio between world trade and the gold stock, but the free market has already moved gold to a level which is not obviously inappropriate.

An individual country does not need an enormous stock of gold, but it does need to have created a sufficiently strong belief that it can maintain its exchange rate. Confidence, not quantity of bullion, is the key condition to the successful operation of a gold standard. The need to maintain confidence rather than actual movement of bullion is why a gold standard does genuinely discipline the financial conduct of its members, and has its stabilising effect.

At the outbreak of the first world war the Bank of England, then still the centre of the gold standard exchange system, had a gold stock of a little over £40 million (£41,400,000 in the first quarter of 1914, the highest ever reported). At constant cost of living prices that would now be the equivalent of a stock of about £320 million, or at constant gold prices a stock of about £680 million. Of course, in 1914 Britain also had a gold currency which was a further, and psychologically highly effective, backing for the exchange rate.

One aim of a national gold policy is to create an identification in the public mind, nationally and internationally, between the national money and a particular quantity of gold. In the case of Britain this was first done by Edward III, who laid down in 1345 that a pound of gold of twenty-three carats, three and a half grains fineness, should be coined into 50 Florences, to be current at six shillings each. So that British currency under Edward III was fixed at £15 to the pound of gold, a rate subsequently changed. So long as it is believed that such a tie will be preserved, currency balances are as good as gold, and better in that they can be invested to produce income. Actual bullion only becomes important when it is thought that the nation will default on its gold commitment. Then you get the international equivalent of a run on the bank; to overcome that you need, and the I.M.F. would be, a gold lender of last resort.

The objective of a return to a gold standard is to return to a world currency of constant value. The objective would be completely fulfilled if there were total convertibility into and out of gold at fixed rates of all the major currencies, both in international settlement and eventually internally. The objective would be to include the Communist powers in this system, at any rate so far as international settlement is concerned. It is therefore no disadvantage that one of the Communist powers, the Soviet Union, is one of the world's two largest gold producers. If this makes the Soviet Union richer, so much the better. One must avoid the bullionist illusion that under a gold standard there is some special value to a gold mine; it is worth the gold it produces, just as an oil well is worth its oil production.

It is more of a disadvantage that the other main producer is South Africa, not because there is any objection to enriching South Africa, which may tend to accelerate the improvement in the condition of black South Africans. The objection is rather that the political and racial crisis which South Africa is liable to face might at some point interrupt gold production and therefore disturb the world currency system. That is a real risk to be guarded against through the organisation of world reserves, though it does not seem as grave a risk as the existing threat of inflation to the world monetary system and to the world's political stability.

In a gold system there is a tendency for trade balances to be stabilised; there is also much greater stability in the terms of trade. Great Britain has suffered an adverse movement of 25 per cent in her terms of trade in the past three years, resulting not surprisingly in a massive balance of payments deficit. Had the pound been tied to gold that movement would not have occurred.

Indeed, the great movement of oil prices reflected the oil-producing countries' reluctance to accept payment in currencies of constantly falling purchasing power. Neither the original inordinate expansion of the use of cheap Middle East oil, nor the inflation of currencies which made the oil producers determined to raise prices, nor the actual scale of the increases would have been likely to arise under a gold system. The gold ratios are surprisingly strong, and one saw that the rise in the oil price was accompanied by a comparable rise in the price of gold on the free market.

Obviously the oil countries will have, and should have, large surpluses, whatever system of pricing and currency is adopted. Yet the problem of investing these surpluses, as well as the problem of unstable movements in oil prices, would be easier to handle on a gold standard. Because gold holds its value, a prudent investor would hold, and historically has always held, longer dated, lower interest gold securities than paper securities. The flood of short-term Arab money, which is among other things further inflating the already inflated Euro-dollar market, is bound to be invested short term when the currencies on offer represent only short-term stores of value. What is needed is good money.

'Good money' has always been taken to mean money which is of lasting value, which performs the function of a store of value. This is the essential difference between gold and any paper money, that gold is indestructible, while paper money depends both on the continuance and on the self-restraint of the government of issue. Gold alone, or with silver, meets Locke's celebrated definition of money as 'some lasting thing that men might keep without spoiling, and that by mutual consent men would take in exchange for the truly useful, but perishable supports of life'. The crisis of oil prices and Arab money shows that paper does not meet Locke's definition – and what the consequences of failure to meet that definition must be. Only a 'lasting thing' can secure the 'mutual consent' which is essential both to the exchange of goods for money, and to the investment of the money received.

The adoption of a gold system would leave certain vital questions to be answered. What should be the price of gold relative to the key currencies? Probably a price closely related to the free market price at the time the system was introduced. Should the price of gold be changeable subsequently? Possibly the I.M.F. should have the power to devalue all currencies in terms of gold if a genuine shortage of liquidity threatened to produce a major world depression. Should currencies be fixed in terms of gold, and therefore also in terms of each other? Certainly yes. Should there be a trading margin? Probably not, though bullion trading would take place at a premium to pay the costs of the trade. Should there be provision for devaluations and revaluations? Recent experience has weakened the belief that devaluation or revaluation can be relied upon to correct imbalances of trade, but in extreme circumstances they may be inevitable. Can the Bretton Woods machinery, the I.M.F. with its powers, be used to supervise the gold system? Certainly yes.

These are important questions, but the central argument must be restated. Gold is the only permanent international currency. It is the most intelligible of all currencies. It is the only currency which provides a constant world money supply. It is the only currency with a good record as a long-term store of value. It is the only currency which naturally tends to stabilise prices, against both upward and downward movements, therefore acting against inflation and deflation. It is the only currency with a strong tendency to stabilise trade balances and the terms of trade. It is the only currency which naturally stabilises long-term interest rates at a low but positive level. It is a standard of value which allows a variable economic system to be co-ordinated.

Apart from the gold inflations, particularly those of Alexander the Great and Philip II, which happened for reasons most unlikely to recur, gold has a consistent record of actually securing price stability. Whenever and wherever gold currency has been used, long-term prices have been stable and short-term price movements have been moderated. The record of managed currencies is the opposite; no managed currency system, not linked to gold, has provided price stability, and most such systems have been grossly inflationary.

We are involved in a major world inflation, the worst in the world's history, which has now reached the stage when prices are still rising, but economic activity is being depressed. We have a choice between two systems, one of which has quite consistently prevented inflation, while the other, our present world monetary system, has consistently produced it. Neither system has consistently produced full employment, but rapid inflation has quite consistently produced heavy unemployment.

The freedom of action which is lost in restoring a gold system can now be seen to be illusory. It is in fact freedom to turn a stable system into an unstable one, a constant money supply into an inflated money supply, a self-equilibriating system into a self-destroying system, an objective system into a subjective one. The freedom of action which matters, that of choosing the form of society in which one wants to live, is actually strengthened by a gold standard; gold provides the price stability on which political societies can be made to survive.

Gold also imposes on man a respect for economic resources. The quantity of gold is finite, because gold is one of the mineral resources of the world. The quantity of oil, coal, copper or human labour is also finite. Gold belongs to the family of real economic resources whose exchange it is supposed to regulate.

Paper money is infinite; one can write down $100 or $100 million or $100,000,000 million on the same piece of paper; there is no shortage of noughts. If we measure finite resources in finite money we are less likely to indulge in the mania of extravagance that has marked the last fifteen years, that has squandered irreplaceable resources and polluted our planet. Sanity in society can be shown to depend on sanity in money; it appears that the same is true of sanity in the use of resources as well.

Senator **Sasser**. Let me ask you this question. You seem to be advancing the theory that we need policy in this country—a strict monetary policy. Would you recommend that this country, this Government, adopt the same strict monetary policies that the Thatcher government is following in Great Britain?

Mr. **Britt**. I don't think we can compare ourselves with that government, but I'd like to compare monetary policy and fiscal policy as being two completely different things: a lot of people don't really understand that. Monetary policy has to do with the Federal Reserve System; fiscal policy has to do with taxing and revenue raising, selling bonds. When those two things, in any given country, are pulling in different directions, you are going to have economic stress.

When I worked for the Federal Reserve System, for about 16 years, when I would give speeches to Rotary Clubs and places like that, especially in communities within, let's say, 100 miles of here, I would often compare fiscal policy going north, and monetary policy going east. To a farmer in the field, either using a tractor, or two tractors or some oxen or some mules, trying to pull a stump out of the middle of the field, if one power source is going north and one is going east, the trunk comes out of the field and goes somewhere in between. Monetary policy and fiscal policy have to be going in the same direction; they have to be in sync. And until they are, both in England and here, we will have stress and the place where the stress comes in interest rates. The Federal Reserve and the Government are not in sync at this stage.

Senator **Sasser**. Is it your view that we follow the proper course of action in adopting a tax cut, or should we have foregone the tax cut legislation?

Mr. **Britt**. I think the tax cut was in order. I think that if the President's program were delivered more in the way it was originally presented, by reducing deficit spending, that we would be a lot farther towards lower interest rates than we are today. And that still remains the problem.

Senator **Sasser**. But in a situation where you have a strict monetary policy, which is now being followed by Mr. Volcker of the Federal Reserve Board, when you have a large tax cut, which we are now undergoing, you have a fiscal policy—an expansionary fiscal policy pulling in the opposite direction?

Mr. **Britt**. That's correct.

Senator **Sasser**. Now, you just got through telling me that is similar to two tractors in a field pulling in a different direction on a stump, and you don't know where it's going to come out. And one economist has characterized a strict monetary policy that the Chairman of the Federal Reserve Board is pursuing, vis-a-vis the expansionary fiscal policy which the administration appears to be pursuing, is attempting to go up and down the stairs simultaneously. One man can't go up and down the stairs at the same time; it just simply can't be done. Would you agree with that analysis?

Mr. **Britt**. Well, I wouldn't use those exact words, but a balanced budget is an absolute priority in this country, and until you get a balanced budget, which I believe is the administration's approach, and that's planned in the next fiscal year, but they're having great difficulty even getting through fiscal 1982 with the current recession that we're entering. So that the difficulty becomes those people that vote, in the

House and in the Senate, must get in sync with both the administration and the Federal Reserve System or we will continue to have interest rates remaining high.

The only other alternative is to change the Federal Reserve System, because the way I read it, the way I think that those ladies and gentlemen are tending to go, is they're serious about it. I'm sure that's one of the reasons for the hearing.

Senator **Sasser**. We thought we were getting in sync with the administration when we passed the tax cut, but we find we have expansionary fiscal policies pulling against a highly restrictive monetary policy that is pursued by the Federal Reserve Board. And both myself and many other Members of the Congress, and many economists, wonder about where in the world this is going to lead us.

Now let me ask one final question, and then we'll get on with the next panel. It appears to me that what we're seeing now are some of the highest interest rates that we've seen in this century. Now, traditionally, interest rates have run 2½ to 3 percent ahead of the rate of inflation. There appears to be general agreement about that. Now, we see the interest rates running 10, 12 percent ahead of the rate of inflation. We are told that the reason for these high interest rates are excessive demands for credit, yet we see in one afternoon, Du Pont putting together a $4 billion line of credit to buy Conoco. Now, if that can be done, does this not indicate to this panel that there is a sufficient quantity of money available if you're just willing to pay the interest to borrow the money. And if there is not a crunch, as far as getting the money; that is, an excessive demand for money, what's causing the interest rates to stay up? Is it really the policy of the Board?

Dr. **Flexner**. I would say it's largely the policy of the Board. As you know, the rest of the world is holding around $1,000 billion—maybe more by now—in dollars which came from the energy crisis and other things, and the dollar tumbled pretty low. And Volcker, as you know, he's not an economist, he's an international banker, essentially, by background. And his main concern is to keep the dollar strong; the Federal Reserve has been, certainly, for some time now, very much concentrating on the dollar in international affairs—more so, in fact, than I think on the dollar here. Which is one of the reasons the interest rates have gone so high, and which is one of the reasons, of course, that people like Schmidt and Mitterand and others who came to Ottawa were complaining because the high interest rates are drawing money to America, away from other countries and it's causing a depression there. I think this is a major part of high interest policies, but actually the interest rates are much higher, I think, than the real rate of inflation, in any case. And as you say, that has not been the case usually; usually they run very slightly ahead. I think the idea here is that the balanced budget, high interest rates, and tight money will put us back on course.

And I think that's completely wrong, because they will destroy incentive, they will destroy the innovative qualities of the American system, and they will create a lot of harm. But this is artificially created; this has nothing to do with supply and demand for money, because, as you know, hundreds of millions and billions of dollars are not going into, today, productive investments, but big corporations are building $300, $400, $500 million office buildings in Rhode Island and Connecticut and elsewhere. A lot of the huge credit that is being absorbed today is being stored in real estate, because investment opportunities don't require it. So I would disagree that there is this excessive demand for credit which is raising interest rates. The excessive demand is far more speculative than it is productive.

Dr. **Bies.** I'd like to add one thing, too. I think the biggest thing that's different about this high interest rate cycle, compared to that at the end of the sixties and 1973, is that back then if you looked at savings and loans or banks, when interest rates went high we lost our depositors. They went ahead and put it in U.S. Treasury securities. And as a result, as Mr. Britt said, when you didn't have any money coming in, you started to ration credit. And so you have immediate impact, where you cut off your borrowers much sooner.

That's not happening this time, to the same extent, because we now—through the Monetary Control Act of 1980—are able to pay market rates and keep deposits. So the rationing is coming through high interest rates this time, instead of no money at all.

The second comment is to the overall spread between the rate of inflation and interest rates. I think what the market is saying to us is the risk of doing business is much greater in this country today than it ever has been, and that risk is an uncertainty about profitability. For more than a decade each President has promised a balanced budget, controlling inflation, getting the economy back in shape, and we are getting worse and worse instead of better. When you go to a market where you've got greater risk holding a corporate bond or a U.S. Treasury bond than you have in just sitting and doing nothing, you don't make the investment. The rate of return on equity in our corporations today, for most of them, is probably less than the rate of interest that the Treasury is paying for their debt, and that is saying no one wants to take that risk until we show a consistent, predictable economic policy; and until we really see results, you're going to continue to see a six to seven point spread over inflation—as a risk of making a long-term business decision.

Senator **Sasser.** What you're saying, in essence, Doctor Bies, and I'll sum it up and move on, is that the lenders are transferring the risk of inflation from themselves to the borrowers now.

Dr. **Bies.** That's right. And we have to; 1 out of 10 of us is on a problem list.

Senator **Sasser.** Well, thank you very much for appearing today, and we may very well ask some additional questions which we will propound to you in writing, and we'll appreciate a prompt response.

Thank you very much.

We'll move forward here with Mr. Tribo of Pryor Oldsmobile, who will tell us how great things are in the automobile business. If you would give us the benefit of your views, Mr. Tribo, we would like to hear it.

STATEMENT OF JOE TRIBO, PRYOR OLDSMOBILE, MEMPHIS, TENN.

Mr. **Tribo.** Thank you, Senator Sasser.

What makes small business especially vulnerable to high interest rates? The answer is simply the money—for the most part, borrowed money—is the very lifeblood that small businesses feed upon. When the cost of the borrowed money continues to use up the major portion of the gross profit generated by that business, you walk a very tight rope to survive, particularly when you're selling a product with a relatively small markup and paying interest rates that are more than double the margin of profit. Now these are the facts that we live with, without addressing ourselves to the tremendous increases in fixed expenses. We can exercise some control over these expenses by reducing personnel and other expenses, within certain limits, but we have no control whatsoever over the rate of interest we pay.

I have listed some concrete figures that graphically point out the validity of what I just stated. In 1976, we had a gross profit on total new car sales, an average of 9.6 percent.

(Material follows:)

	1976	1977	1978	1979	1980	1981 through September
Percent of gross profit on total new car sales	9.6	8.7	8.6	8.8	8.0	7.6
Cost of interest paid for new car inventory for the year (percent)	0.4	0.6	0.8	1.3	1.7	2.7
Cost per new car sold for floor plan inventory	$26	$42	$60	$106	$152	$274

Senator Sasser. Nine point six?

Mr. Tribo. Nine point six percent was our average in 1976. The cost to inventory our new cars was four-tenths of 1 percent of our sales, or $26 a car. In 1977, our gross profit dropped to 8.7 percent; the cost of inventory was 0.16 of 1 percent of our sales, or $42 a car. In 1978, 8.6 percent was the gross; eight-tenths of 1 percent was our interest charge, $60 a car. In 1979, 8.8 percent gross; 1.3 percent, or $106 a car. Now, mind you, on these percentages of gross profit, we were making more dollars per car, but we were not able to keep up with the increased price of the car because of the competitive nature of our business. In 1980, our gross profit was 8 percent; cost of new car inventory, 1.7 percent, or $152 a car. In 1981, through September, our gross profit has been 7.6 percent; 2.7 percent is the cost of maintaining that inventory or $274 a car. Now that ought to refute Doctor Bies' testimony—that the increased cost of the car is mainly responsible for high interest cost. The percentage cost of interest has increased from 0.4 percent to 2.7 percent or seven times the cost 5 years ago. All other factors being the same, and using interest factors for 1976, 1981, would be a banner year for Pryor Oldsmobile Co., but that's not the case. The frightening fact is that currently, interest is eating up 36 percent of the gross we are making on the sale of new cars.

Now, I've referred to the direct expense incurred by the sale and stocking new cars; however, another pertinent fact has to do with the mortgage interest. We are in the sixth year of a 10-year loan, with an equal monthly reduction of the principal, and a floating interest rate. Our total interest paid for the past year, 1980, was 26 percent more than our first year of the loan, although the principal is down to 50 percent of the original amount. We are fortunate enough to have built a new facility in 1970, and have a mortgage we can still live with, but there are many new facilities that will find it impossible to survive if relief is not forthcoming very soon.

Normally the solution to overcoming these excessive interest costs is to increase sales volume and turnover in merchandise. This is not possible; we are faced with decline in volume and a slower turnover because of the customer's unwillingness or inability to pay the cost to finance it, even though currently the retail interest rate charged to customers is well below the rate we pay for floor plan.

Now the lending institutions—of course they say they've only gone up 2 percent on financing, but you talk to many of them today, and they're not too interested. They're very indifferent. It's almost impossible to get them interested in financing new car sales. Now, I don't blame them, when they could make more money doing business with the Government; I mean, I'm not criticizing them, you know.

The positive effect that reduced interest rates can make was dramatically displayed during the month of August. General Motors offered a 13.8 interest rate on all GM cars sold during the month of August, and sales were at record levels nationwide. Thirty days later, with the introduction of the 1982 models, and the consumer rates back to the previous high levels, we are experiencing the slowest new car introductory sales since 1958.

Now, it's my understanding that the Federal Reserve policy intentions were to slow down rapid inflation, and to make the American public face the facts of life. Well, gentlemen, they've succeeded, but enough's enough. We need relief now.

The NADA, which is the National Automobile Dealer's Association, has joined forces with the housing industry to persuade Congress to unlock the economy. These three national associations, NADA, the National Association of Home Builders, and the National Association of Realtors, are launching a media and lobbying blitz to focus congressional attention on the traumatic effects of high interest rates—that the traumatic effects that high interest rates have on auto and housing industries. This was kicked off on October 6, and they have presented these facts to Secretary Regan, and they're urging him to take the following action: three things; that they are urging that the President and Congress should take whatever steps are necessary to hold the budget deficit to $42.5 billion in the fiscal year 1982, and to balance the budget in the fiscal year 1984. The Federal Reserve must consider the need for general economic recovery and financial marketplace ability, and a consistent program of monetary growth within the target ranges reported by the Congress for 1981. Third, and I think, most important, is the President should appoint a nonbanking small business representative to the Federal Reserve Board.

If small business is to survive, we need to return to a stable and reasonable rate of interest now. We need to get off the pogo stick that made 39 changes in 1 year necessary. I feel there is no solution, however, that will be good for just small business alone. The only true solution must bring about a stable national economy; big business must flourish to keep the employment levels up and put money into the pockets of millions that makes small businesses successful. Thank you.

Senator SASSER. Thank you, Mr. Tribo. I want to ask you this—do you agree with this statement that Doctor Bies made, that interest rates play only a small role in the financial difficulties of small businesses?

Mr. TRIBO. Absolutely not. I just said, well, you can see, the percentages don't lie.

Senator SASSER. Interest cost up from $26 per auto in 1976, according to my notes, to $274 per auto in 1981.

Mr. TRIBO. Well, four-tenths of 1 percent against 2.7 percent is a strong figure.

Senator SASSER. Right. You might be interested in knowing that at the time of the appointment of the last member of the Board of Governors of the Federal Reserve Board, I introduced a resolution that passed the Senate, stating that thereafter the next appointee to the Board of Governors of the Federal Reserve System would come from either the farm community, or the small business community, and would not come from the Eastern banking community, or from the academic community. We introduced this resolution and it was passed in the Senate, in an effort to stop the filibustering that myself and one or two Senators were pursuing to stop the appointment of the nominee of then President Carter from going on the Federal Reserve System. And I continue to think that it's very important that we breakout of this narrow classification of people who go on the Board of Governors of the Federal Reserve System. They are generally two types of people: Large Eastern bankers whom you have heard Chairman Volcker describe as international bankers, or academicians, professors of economics who have gone with the Government. Eastern bankers or economists always seem to be chosen, but we just need to have broader representation on that Board so that some of the people who are making this policy will know something of the human and economic costs of the policies they pursue.

Well, you didn't come here to hear me lecture; I came here to hear you.

Mr. Willis, if you will tell us about the homebuilding industry—what the impact of high interest rates are on your business?

STATEMENT OF BOB WILLIS, PRESIDENT, HOME BUILDERS ASSOCIATION OF MEMPHIS

Mr. WILLIS. First, let me apologize for being a little bit tardy; I was out back trying to get some of that 16½-percent money that Dr. Bies mentioned. My lenders haven't heard of that; I've been paying as high as 22 percent on some of my construction loans.

Also, I am a homebuilder and I feel like that stump that Mr. Britt mentioned. I've got high interest rates being charged by my lenders tugging at me one way, and the desperate need to operate a small business and make a living tugging the other way, and I'm not sure which way I'm going to go when I finally pop.

Seriously, though, the Memphis and Shelby County housing industry is suffering its longest depression since World War II. We've been watching rather helplessly for months, as high interest rates continue to prevent the average home buyer from qualifying for a new home loan. The demand for housing is evident, but the ability to qualify has closed the lid on that demand. While special financing packages, such as things I'm sure you've heard about, like buy-downs, et cetera, are helping to sell some of our existing inventory, very few new homes will be built as long as these conditions of high interest rates exist.

Total inventory in Memphis has been reduced slightly during the past 6 months, but more than 2,400 new homes still remain in Shelby County's housing stock. These homes represent more than $2½ million a month in interest carrying costs for our builders. Now, let me say this—$2½ million a month to small business people is a lot of money. And still, very few sales are being generated to help offset these costs. Our industry simply cannot survive long at this rate. I've already seen builders face foreclosures, and some facing bankruptcy. I might inform you that about 95 percent of our builders in Memphis and Shelby County are small builders, building under 10 houses per year. And a comparable percentage of our subcontractors and suppliers are in that same category, so they are small business people.

We've seen a major portion, also, of our labor force have to seek employment in other industries. And this is understandable when you consider that only 180 permits were issued for new housing starts during this last 3 months of 1981, and during the same period during 1980 we had 1,097 permits issued. That's again 180 in the last 90 days, 1,097 for the same period a year ago. This is a drop of over 83 percent. I've seen subcontractors and suppliers go out of business, and I'm sure more will be forced out as builders go under, unable to pay their bills.

Well over half of our labor force is either out of work or working on a limited, part time basis—and this is much lower than that 8 percent national unemployment figure you mentioned earlier.

Senator SASSER. Well, it's about 15 percent, the last I heard.

Mr. WILLIS. I'll say, about half of them, 50 percent of them, are either unemployed or on a very limited basis.

The real effect of this reduced labor force and reduced production will be felt later, as demand for new housing continues to grow. Our local Home Builders Association currently is hosting the 1981 Home-Fest, which is the exhibit of our new homes. We attracted more than 40,000 people at the site in 2 weekends. This turnout is proof to us that the demand for new homes is as strong as ever, but the big question which remains in these potential home buyers' minds, however, is qualifying for a loan on that new home.

Part of the problem in untangling today's interest rate challenge as we see it, lies in the continued practice of setting monetary policy based on national statistical reports which are, at best, often misleading. For example, reports of national housing starts show them about 50 percent under demand forecast. Although that in itself is a substantial slowdown from the past, it still suggests activity in the total market. In reality, the 10 fastest-growing market areas like Houston, Dallas, some Florida and some southern California cities, artificially inflate these national statistics. If you exclude these areas from the national figures, you will see that starts in the remainder of the country are off about 80 percent. And Shelby County and Memphis is certainly in that category.

Another misfortune of relying on national statistics lies in the way high interest rates affect a variety of industries which are lumped together in reports on economic activity. Some businesses can add higher interest rates to their cost of doing business, and in turn, their prices to cover those costs.

Increased prices have little effect on such noncompetitive industries such as defense-related, energy-related, or high-technology industries. Even a lot of the small, consumer-oriented industries can pass their increases on to the consumer without substantially reducing the demand for their product. An example would be a new shirt going up 25 cents, a can of car wax, a loaf of bread—that type of thing. These industries actually inflate national economic activity figures and hide the true problems of those industries that rely on consumer credit to sell their product—namely, the gentleman next door with his car, and us with our new homes. We believe it is not the price of a new home that consumers cannot afford—and again, this is contrary to what Dr. Bies stated—we feel like it's the effect of the high interest rate on a monthly payment that keeps them from qualifying to buy these houses. True, the price of new houses is up, but it's not necessarily the higher price, but rather the higher interest rate on that monthly note.

It is truly unfortunate that giant conglomerates can tie up billions of lending dollars while they negotiate mergers with other companies, with no thought of what interest rates they must say, yet at the same time, a young family here in Memphis, Tenn., making approximately $30,000 a year, can't qualify for a $50,000 home loan. And let me tell you, you can't buy much of a home today for $50,000.

The Home Builders Association of Memphis and the National Association of Home Builders certainly back President Reagan's policy to balance the Federal budget. We recognize the importance of getting Government out of the private money market. Further, the Home Builders Association is not asking for direct Government subsidies to bail out the housing market. Here is what we'd like the Government to do, and some of it is repetitious: Balance the budget by 1984; item No. 2, have the Federal Reserve increase the money supply to the upper limits of its target range, hopefully making mortgage rates somewhat lower; again, as you mentioned earlier, appoint a small business representative to the Federal Reserve Board so the little businessman will have some input; take immediate steps to allow mortgage bond—mortgage revenue bonds to be issued, making lower rates available.

The home building industry here in Shelby County last year was absolutely saved by two local mortgage bond issues, one for $150 million, and the second for $50 million. I'm sure the Senator from Arkansas is familiar with that; I think over in Little Rock, they did that—a tremendous boost to new home ownership. Item No. 5, adopt amendments to the Employment Retirement Income Security Act to permit private pension funds to invest significantly in residential mortgages. Also, we ask that the Government recognize that the Consumer Price Index needs to be changed to reflect more realistically housing's affect on the index. Currently, housing carries too much weight in the index, particularly because of the fact, the fact is that high interest rates have caused the rapid increases in housing, and not the actual brick and mortar cost of a new home. So for heaven's sake, let's see if we can't do something about the Consumer Price Index.

We home builders understand that this country must get inflation under control, and our industry is trying to do its part by building smaller, more cost-effective homes on smaller lots. We continually work with local, State, and Federal governments to reduce regulations to allow more creative housing developments.

We can and will do our part, but we cannot control the money supply; we cannot control Government spending, and we certainly can't control the Federal Reserve. For that, we must rely on people like you, Senator. We are not only fighting for the survival of our industry, we are figthing for the ability of all Americans to attain the "American dream" of owning their own home, an investment in the future of their families and the future of this country.

We, the home builders of Shelby County, urge you and the Congress to do all that you can to get interest rates back to a reasonable level, so our people can continue to buy and own their own homes.

Senator SASSER. Thank you, Mr. Willis.

[The attachment to Mr. Willis' prepared statement follows:]

SHELBY COUNTY PERMIT* UPDATE

	1977	1978	1979	1980	1981
JANUARY	223 0	302 2	77 0	234 1 duplex	209 33
FEBRUARY	197 265	190 154	155 0	171 85	122 0
MARCH	413 19	435 156	331 0	157 3	199 5
APRIL	400 0	374 192	304 1	103 0	107 50
MAY	395 88	353 3	290 0	289 0	149 14
JUNE	385 460	437 6	485 0	202 0	125 6
JULY	359 0	306 22	262 0	247 6	59 0
AUGUST	400 0	326 80	244 0	629 8 condo	26 0
SEPTEMBER	299 4	461 32	285 0	221 24 condo	95 26
OCTOBER	406 200	381 245	232 41	283 7	
NOVEMBER	362 0	229 16	262 0	266	
DECEMBER	351 12	365 14	159 0	101 8	
TOTAL	4190 1048	4159 922	3086 42	2903 142	
JAN-AUG-TOTAL	3604	3338	2149	2135	1112
Total permits	5238	5081	3128	3045	

LEGEND:

Single family / Multi-family

*Permits issued in Shelby County, TN, including Memphis and other incorporated areas.

Senator Sasser. Let me ask you a question—if you had your choice between deferring the tax cut for the next 2 years or choosing a 10-percent mortgage rate, which would you choose?

Mr. Willis. The latte[illegible] personally would be glad for them to keep my tax cut, and appl[illegible] it to the national debt. It's not going to help me that much, but I certainly prefer to see a 10-percent mortgage rate.

Senator Sasser. Our next witness is Mr. Bob McCarley of McCarley & Co., Realtors, in West Memphis. He's going to tell us how good the real estate business is over in West Memphis.

STATEMENT OF BOB McCARLEY, McCARLEY REALTY, WEST MEMPHIS, ARK.

Mr. McCarley. Thank you, Senator. I'd like to give some background information that I think is necessary before any meaningful comments or suggestions as to possible solutions to the current interest rate problems could be presented.

Some facts which are the result of high interest rates include the situation that only one new single-family residence is currently under construction in West Memphis, a city of approximately 30,000 people. During the last 6 years, 713 new houses have been built, or an average of 119 per year. For 1981, only 27 new houses are going to be built.

One of the largest real estate brokerage firms in our city had 16 sales associates in 1980, that earned an average of $9,000. As of right now, this firm has eight associates, and a projected income of $5,000 to $6,000 for this year.

There was an interesting article in last week's Memphis Press Scimitar which said that for the first time in 13 years, the Chandler report, which is a detailed housing study of Memphis and Shelby County, would not be published. The report was published, but the newspaper thoughtfully declined to print the results, which showed that housing sales were down 36 percent from a corresponding period last year. Mr. Chandler quoted that housing sales were down 50 percent, and that was in addition to a drop of 20 percent from the previous year.

I have reviewed three house sales from 1979, 1980, and one that was closed in June of 1981 with a local savings and loan, to try to tie down the changes in price and mortgage payments over that 2-, 2½-year period of time. The sales price of the house—and this was a very similar house in the same location, same size—the sales price of the house had increased 28 percent in the 2-year period, while the mortgage payment, with a 90-percent conventional loan, had increased from $428 to $923 per month, which is a 116-percent increase. Theoretically, the salary of the purchaser would have had to have doubled in the same 2-year period of time. Very unfortunately, wages and salaries have not doubled in that period of time. The direct cause of the above-described circumstances is high interest rates. The end result is going to be that the real estate industry cannot survive a continued period of extremely high interest rates. Very few businesses and individuals involved in somebuilding, housing, general real estate, and related fields will be able to survive extended periods such as we are now going through. Real estate is such a capital-intensive industry that financing conditions greatly affect the amount of business that is being done.

Addressing the specific question of what makes small business especially vulnerable to high interest rates, many small businesses do not have the financial resources to weather extended periods of poor business conditions. They are unable to borrow additional money and make satisfactory repayment schedules with excessively high interest rates. The next question is what, if anything, can or should be done to aid small business in coping with the impact of high interest rates? Of course, high interest rates affect both large and small businesses, but larger businesses seem better able to weather the storm. They also oftentimes have captive markets, which enable them to pass on the added interest costs. This situation also adds to our rate of inflation.

The next question is what steps should be taken to avoid an environment in which high interest rates become a key instrument of national economic policy? The economy is so involved that there is no simple solution to the problem. High interest rates cause unemployment, which in turn causes increased Federal expenditures, which in turn requires additional borrowings by the Federal Government, which in turn lead to higher interest rates. The major step that needs to be taken to avoid high interest rates is for the Federal Government to become less of a borrower and operate on a balanced budget. The Federal Government is by and large the—by and away, the largest borrower of funds and is in turn forced to pay going market interest rates. Interest cost of the Federal debt only adds to the deficit. The artificially high interest rates only make the job tougher, of trying to balance the budget.

Our national economic policy should be based, to the greatest extent possible, on pure supply and demand from the private sector. Interest rates cannot do anything but remain at record high levels as long as the Federal Government has to borrow the sums which it presently does to fund the debt.

Our economy is a very complex animal, and there is no easy solution, or short-term solution, to a long-standing problem. Current high interest rates are the result of many years of excessive deficits by the Government. These problems cannot be solved overnight or painlessly. An attempt to develop a system of rationing credit would, to me, be a grave mistake. One possible step, as part of a solution, would be an across-the-board rollback of interest rates. This situation would appear to help borrowers, not hurt lenders, and the Federal Government would be considerably better off, for the obvious reasons. There is no end to the possible ideas or solutions that people have for improving the economy, but no one answer will make everybody happy.

Senator SASSER. Thank you very much, Mr. McCarley. You made the statement that high interest rates cause unemployment—and I agree with that—which in turn causes increased Federal expenditures, and that's correct, because for every 1 percent that the unemployment rate goes up in this country, it costs the Federal Government on the average of about $22 billion in lost revenues that would have been realized if these individuals were working and in payouts to the unemployed. And you go on to say that high interest rates cause unemployment, which in turn causes increased Federal expenditures, which in turn requires additional borrowing by the Federal Government—and that's true—which in turn leads to higher interest rates. Well, I suspect that's true too, and we find ourselves here in a vicious cycle. But I think one way to reverse this cycle is to try to move interest rates down and get the economy moving again. We're not going to have an economic recovery in this country until we do something about interest rates, and any talk of economic recovery programs with interest rates at 18 and 20 percent, is just that—talk.

There's never going to be an economic recovery program until we get interest rates down. And I think if we get interest rates down, then we'll see this vicious cycle, as you pointed out, perhaps starting the cycle down. The interest rates go down, and that creates demand, and that creates employment, and perhaps revenues to the Government will go up, and we'll have lower taxes. I think the last time we had a final budget, we had unemployment in this country at 3.6 percent. We've now got unemployment, Dr. Flexner said, I think, 7.5 percent—I think that's correct. Well, with an average cost of $22 billion for every 1 percent of unemployment, you can see what would happen to us pretty quickly, if we could pull that unemployment figure down 2 or 3 percent, and do it without creating inflation.

Mr. Merrell, we'd be delighted to hear from you now.

STATEMENT OF VIRGIL C. MERRELL, MERRELL ASSOCIATES, FORREST CITY, ARK.

Mr. **Merrell**. Thank you, Senator. I appreciate the opportunity to participate in the panel today.

In my business, which deals with motels, hotels, and restaurants, I observe almost on a daily basis, the devastating effect of high interest rates on small business. Exorbitant rates, coupled with the tight money supply, has driven many people in our business to the wall. In too many cases, it is no longer a question of whether or not he will go under; it's now simply a matter of when.

Business failures and closings in any industry are unfortunate and, of course, affect numerous individuals and businesses beyond their own threshold. Failures within the hospitality industry are often accompanied by greater shock waves and more widely felt economic effects, due to its labor-intensive nature, and its employment of massive numbers of unskilled persons.

When a lodging facility or restaurant in this area is forced to close, many persons with the least skills are thrown into the labor market with little chance for employment.

We are talking about small business, the backbone of America. We are dealing with the hopes and fulfillment of the great American dream. We are observing now the demise of the family-operated enterprise. We are standing on the threshold, about to witness increasingly longer lines of the unemployed stretching across our land, primarily the result of high interest rates and the tight money supply.

Traditionally, the profit margin of small business has been small, but sufficient, in most instances, to meet demands necessary for the business to continue. Although they are sometimes undercapitalized, through great determination, imagination, and ingenuity, the American small businessman has often succeeded in the face of overwhelming odds. He has given to the Nation a heritage and strength found no other place in the world.

Today, we are witnessing a vanishing breed, a lost American institution, a fading of the American dream, and the immediate effect can be attributed to the cruel forces in the money market—high interest rates and tight money.

I am keenly aware that bankruptcies and business failures are occurring in every type of business; however, I am more familiar with problems of the industry in which I am deeply involved on a daily basis, the lodging and restaurant industry. The experiences of this industry can be effectively translated to reflect rather accurately those similar experiences in other unrelated industries. You will understand that my references and related experiences are confined to my field of expertise.

Small business is no longer hedged about by a wall of protection. Underfinanced as it may be, starved for funds as it may be, it still must compete with big business which has ready access to the financial marketplace. It is forced to operate in a competitive arena with one hand tightly tied behind its back.

Public demands on the hospitality industry dictate that furnishings be modern, and that the range of services be extensive. These demands require substantial expenditures. Big business has no great problem acquiring the necessary funds to meet such demands. The small businessman, on the other hand, seeking a loan today, is reminiscent of the country grocer or the tenant farmer of the dreadful depression days, who entered the local bank, hat in hand, and accepted whatever he could get. The small businessman has no leverage at the bank.

Although the picture of the past year is rather bleak, the full implication still lies ahead. Unless interest rates can decline by a substantial degree, and unless more money is made available to small business relatively soon, a proliferation of bankruptcies and failures loom on the horizon. I am personally aware of a number of businesses once considered successful by small business standards which are simply hanging on by their fingernails, waiting and hoping, but with little relief in sight. As a result of frequent contacts with motels and hotels and restaurants in Arkansas and Tennessee, we are aware of the hopeless plight of many unless some relief comes very soon.

During the past year, a number of hotel and motel operators have lost their franchises, simply because funds were not available to maintain the required standards of the franchisor. The net effect is loss of business, a decrease in service, consequent loss of jobs resulting in a loss of more business, and the cycle continues until, in most cases, the business is lost. The tragedy of this example is that we see the trend accelerating and the number of such cases increasing rapidly.

We do not have to reach far back in our memories to a time when necessary funds were available to these same businesses. Unfortunately, in today's market, big business and big government get to the well first. When the small businessman arrives, the well is dry, or if any funds remain, the interest is so high and the terms so restrictive, that his profit margin is insufficient to service a loan.

Let me give you one example involving two recent, quite similar, failures in one town within a very short timespan. Unfortunately, their counterparts could be called legion.

Two restaurants, located in a rather prosperous town, family owned, both remodeled and refurbished within the past 2 years in order to meet competition from the well-financed national chains which were moving in at a rapid pace. Both had borrowed money tied to the prime rate, adjusted monthly. Then, the unforeseen occurred. The prime rate accelerated dramatically, increasing monthly payments substantially. The economy slowed—and whether or not you want to call it a recession, it was certainly a recession for them—profits were no longer sufficient to pay the monthly payments. Today there is a bankruptcy notice nailed to the doors of these two prosperous businesses—or once-prosperous businesses. Scores of employees have lost their jobs. Families have lost businesses in which their lives and their savings had been invested.

Twin scourges of high interest rates and tight money are stifling the small businessman, destroying his incentive, casting a shadow across the future of our country.

I submit to you that the time has come when a solution must be found. For many, it is too late. It is time to take action to lower interest rates and to increase the availability of money. The consequence of inaction is frightening.

Senator SASSER. Thank you, Mr. Merrell. That was a very graphic description of problems of the people in the hospitality industry, and small business in general, is experiencing, and I must say that I agree with you. Unless interest rates come down, and come down rapidly and soon, there are frightening prospects ahead for many people.

Let me say to our friends from Arkansas that we certainly appreciate your coming today, and had it not been for very extenuating circumstances, Senator Pryor would have been here. He has been one of the leaders in the Senate in the fight to try to lower interest rates, and I know that this is a question that is very near and dear to his heart, so I appreciate your coming.

Mr. Tribo, let me ask you, before you leave, the same question I asked Bob Willis. What if I came to you and said, "Joe, we can get you a ten percent prime if you'll forgo your tax cut for the next 2 years." What would you say about that?

Mr. TRIBO. You bet.

Mr. WILLIS. Let me ask you a question. Would you get on Volcker for us pretty heavy?

Senator SASSER. Well, Bob, I've been on him pretty heavy for about 2 years. He came before the Budget Committee, oh, about 1 month ago, we had a very energetic exchange there and I told Mr. Volcker that he simply had to retreat from this high interest rate policy of his. I said he could stay on it, and that eventually we would have lower interest rates. Eventually, we might get the deficit under control. But they had low interest rates right before the depression. Where this is pushing us, in my judgment, if it continues on, is to extraordinary high unemployment figures. I don't think we can fight inflation with just strict monetary policy; I think we're seeing the failure of that right now in Great Britain.

Mr. REED. It might do him good, if he could come and hear this kind of thing.

Senator SASSER. Well, he invited us over to have lunch with him, and I'm going to go over and have lunch with him after I get this record transcribed here, of all this testimony, and we're going to read portions of it between courses over there at lunch.

Gentlemen, thank you for coming.

Well, next, we're going to hear from a two-man panel discussing the problems that farm-related businesses are experiencing due to the interest-rate situation.

We will hear from Mr. Stanley Reed, a farmer from Marianna, Ark., and also Mr. Charles Moseley, a farm implement dealer from Blytheville, Ark.

Gentlemen, welcome. We appreciate having you here today, and Mr. Reed, we'll just start off with you. I think you've got a prepared statement that you previously submitted; we'll just get going with that.

STATEMENT OF STANLEY E. REED, FARMER, MARIANNA, ARK.

Mr. REED. Thank you, Senator.

The business of agriculture, as we all know, is the No. 1 industry in America. Farm experts are expected to reach $45 billion this year, while imports of agricultural products will be about $18 billion, resulting in an agricultural trade surplus of some $27 billion.

In comparison, nonagricultural trade will sink to a deficit of $50 billion. Thus, the contribution of agriculture to our balance of trade and strength of our own economy is unquestioned, and the American farmer can stand proud in his accomplishments as a provider of food and fiber, whose productivity and efficiency are unequaled in the world.

The ability of the American farmer to produce has never been in doubt; however, his ability to make a profit and continue in business at the present exorbitant cost of production and the present farm commodity prices is an immediate concern to us all.

Many of the problems facing agriculture are not new. The position of the farmer has always been unique from other businessmen, in that he has no opportunity to pass on increased cost of production to his immediate buyer. With a few exceptions in the last century, the farmer has generally been victim to the buyer's market, with little practical control over the price he receives for his commodities or the price he pays for his input items for production. It has been said over and over again that the farmer buys retail, sells wholesale, and pays the freight both ways. From all reports, real net farm income is destined to decline once again this year, to about $21 billion, down from $22 billion for the drought-stressed year of 1980.

Many farmers have kept afloat in the past decade, not by profits from growing farm commodities, but instead, by purchasing real estate with borrowed capital with interest rates much less than the annual inflation rate or the appreciation in land values. As inflation continued to rise, the loan would be repaid in cheap dollars. A few of the farsighted farmers, or those reaching retirement age, cashed in on this bonanza in real estate values and sold their farms for a nice capital gain. However, most of us who wanted to stay in business and continue farming used the increased value of our land to borrow additional sums at higher and higher interest rates to offset production losses.

In the past year, this pendulum has swung in the other direction, with inflation moderating to around 10 percent annually, while interest rates have soared to an unprecedented 20 percent. This reversal has left many farmers without the borrowing leverage he previously enjoyed, and lending agencies are becoming less inclined to make production loans unless the farmer can paint a reasonably good profit picture in his production operation.

One of the questions explored at this hearing is the effect that the current high interest rates have on the business of farming. The timetable of agriculture has always been to plant crops in the spring, cultivate the plants during the summer, and hopefully, with blessing from God, harvest in the fall. During the growing season, large investments are required in the form of seed, fertilizer, chemicals, fuels, labor, machinery, and other input items of production. The vast majority of farmers must depend upon borrowed capital to finance their operations until their products are sold after harvest. Because of the highly capital intensive nature of modern agriculture, we are as sensitive as anyone to fluctuations in interest rates that are charged to commercial loans.

In 1976, the prime rate was 6½ percent, and a farmer could obtain a loan for a fixed rate throughout the short term of a production loan, thus he was locking in his interest costs. Today's prime rate is 18½ percent, and almost all loans have variable interest rates, fluctuating with the prime rate. There are enough variables and uncertainties in farming, without another being added to the list. I might add that last September, our operation made a farm loan that started out at the variable rate of 11.25 percent; in December, when our crops were harvested, the variable rate had jumped to 19.25 percent.

The Kiplinger Agricultural Letter issued on September 4, 1981, reported that USDA economists had discovered that a 1-percent drop in the average rate charged the total farm debt increased net farm income by 10 percent. Assuming the reverse to be true, we see that a 5-percent increase in the average rate charged to total farm debt could cut net farm income in half. The issue of interest rates charged farmers is not a trifling matter. It pierces the heart of our business.

High cost of borrowed capital is an obvious matter in which high interest rates affect agriculture. There are other, more subtle effects, No. 1, since the farmer is the ultimate consumer of fuel, supplies, fertilizer, machinery, and other items of production, the added costs to these products resulting from high interest rates are passed on by the suppliers of these items. Overall production costs for our operation are up 15 percent this year.

No. 2, farmers are often caught in a cash flow squeeze by agricultural lending agencies, and can be forced to sell their products prematurely at depressed harvest prices in order to pay off production loans that are bearing interest at 15 to 20 percent.

No. 3, the Federal Reserve policies that maintain artificially high interest rates have strengthened the U.S. dollar, and while this may be good for our national economy in the long term, it has had devastating short-term effects on our export demand for farm commodities. Since November 1980, our currency has gained an average of 25 percent in relation to other major foreign currencies, thus increasing the cost of our farm products to foreign customers by at least 25 percent. As a result, our export sales are lagging behind last year's levels in certain commodities, adding to the buildup of supplies and further depressing prices on the domestic level.

No. 4, high cost of borrowed capital to finance margins on futures contracts has kept many speculators on the sidelines, resulting in low open interest in the commodity futures market.

No. 5, processors are tightening their belt and keeping smaller inventories of farm products on hand because of the high holding costs.

This, of course, is not an exclusive list of the detrimental effects that high interest costs have had on agriculture, but it is indicative of the snowballing effect that it has precipitated.

My father and I currently farm about 3,000 acres of rice, soybeans, and wheat. In order to counter the increased production costs and sagging profits, we are double cropping approximately 1,500 acres of wheat and soybeans. We have the potential of producing an above average crop this year, but there is little likelihood of showing a profit. For example, soybeans are currently selling for around $6 to $6.30 a bushel. In 1973, which was admittedly a good year for agriculture, we sold soybeans for $9 a bushel.

Rice prices are presently being quoted at $9.50 per hundredweight. In 1973, the average price received by farmers was $15.30 per hundredweight.

Diesel fuel cost was 12 cents a gallon in 1973; presently, we are paying $1.20 a gallon. This is a tenfold increase. A 130-horsepower tractor cost around $15,000 in 1973; today's cost for a comparable sized tractor is $35,000.

We cannot continue to survive with commodity prices of a decade ago when the production costs have more than doubled in the interim. We, as other farmers, have continued in business thus far by forgoing needed purchases of equipment, borrowing against the increase of equity in our land, double cropping more acres, spending less and less on soil fertilization and conservation practices, and relying upon some new Government program to bail us out of frequent crisis situations. There is a point of diminishing return when some of these policies will prove self-destructive.

None of the experts with whom I have talked have any sure remedies for the present dilemma facing agriculture, but almost all agree that the interest rate must decline before any glimmer of profitability can be restored to our business.

It is my belief that a tax-exempt bond issue could provide a source of low-interest money for vital industries in our national economy, such as agriculture and construction. We have had considerable success in Arkansas keeping our construction industry alive by using this means to finance home construction before the Treasury Department discovered they were losing potential tax dollars. It is my opinion that the impetus to our economy providing more jobs, restoring profitability to farming and other small businesses as a result of using the tax-exempt bond issue as a financing tool, would more than outweigh the loss of tax revenues.

In order for the present policy of the Federal Reserve Board of tight credit and restrictive money supply to have the anticipated effect of reducing inflation to more moderate levels, there must also be a corresponding decrease in Government spending. Today's most of servicing the national debt is approaching the $110 billion a year figure. Many inefficient and wasteful Government programs have already been eliminated, but if Congress will continue to tighten its belt on spending, as everyone else has been forced to do, then I personally believe that the Federal Reserve could and will lower interest rates charged banks, thus stimulating more business activities once again.

I do not believe in the theory of Government subsidies, disaster payments, or support prices as a means of saving the American farmer; however, when the political forces move into the marketplace to take up the supply and demand balances, these programs are essential if the victim—that is, the farmer—is to survive.

Most of us believe in a free market concept, and if left alone without artificial barriers or limitations, the law of supply and demand would eventually restore profitability to our business.

The infamous grain embargos of the past have made America an unstable and undependable supplier of farm products. We have been relegated from a supplier of first resort to a supplier of last resort after all of the markets have been exhausted. We abhor the policy of using our agricultural products as an ineffective political weapon, tossed about like a football, when it affects the livelihood of millions of American farm families and farm-related businesses. We support a no embargo clause in the present negotiations with the Soviet grain agreement unless the embargo receives prior congressional approval, and then, only if it affects vital concerns of national security and all aspects of trade, not just agricultural products.

Thank you for your concern about the profitability of American agriculture, especially as affected by current high interest rates. I trust that these comments have made you aware of our problem and the need for immediate action.

Senator SASSER. Thank you, Mr. Reed. Next we will hear from Mr. Moseley.

STATEMENT OF CHARLES E. MOSELEY, JR., FARM IMPLEMENTS DEALER, BLYTHEVILLE, ARK.

Mr. MOSELEY. Senator, I am humbled by the expert testimony offered by those preceding me.

I offer you a short description of my business, my problems, and maybe a little philosophy.

Small businesses are especially vulnerable to all basic changes in our economy, because of their proximity to the consumer. The farm machinery business, specifically, feels the effects of any change immediately. A good crop or a bad crop is followed by a resulting good or bad business, with a certainty and rapidity unmatched in any other retail business I know.

Interest, at its present levels, has the same effect as a bad crop. The farming picture has changed drastically in the past 30 years. We are doing things now with fewer and much larger farmers. These farmers, almost without exception, are having to borrow large amounts of money. The interest cost on an acre of land is quite often one-half the cost of rent, and certainly over one-half of the anticipated profit. This interest is not on high risk loans; production loans are first money—they are repaid with first money. Interest has become the most influencing factor in the farming industry.

The high interest rate is doubling and tripling the risk factor for the farmer. I'm sure I don't have to draw you a picture of how this affects my business. The unrealistic costs of money is affecting the whole operation of our buisness, not just the sales area. Our business, the farm implement business, was built on the strength of special manufacturer's terms. Our customers have been served well because we were able to have large inventories of seasonal merchandise when the farmer needed it. Reasonable interest cost to the manufacturer and the dealer made this possible; it's not so now. The manufacturer now, out of necessity, must manufacture only what he can move fast. High interest costs have forced them to curtail these special terms, thereby driving up to the retailer's cost, and cutting the availability of merchandise to the customer.

I know the basic economics—raise the price of money, lower the inflation rate—true, except maybe when the ultimate consumer is the only one affected. The main culprits—the Federal Government and the money speculators—are not so drastically affected. One doesn't seem to care what he pays for money, and the other can, and does, pass it on. Neither will leave the money market because of the cost.

The sting is being felt by one of the most honest contributors to the gross national product—the producer of food, feed, and fiber. If the interest rate the farmer has to pay does not drop dramatically and soon, only the very strongest implement dealer, and farmer—the top 25 percent or so—will be around in 1983, unless the commodity prices are allowed to reach the inflated levels of manufactured products, labor, and money. Hence I beg your indulgence and add these remarks to my testimony.

The greatest hope for the economy of the Memphis area, the mid-South, may very well be increased exports of rice, soybeans, cotton, and other farm products. Senator Sasser, I implore you, Senator Pryor, and all of our Washington delegations to join with other farm States to do whatever is necessary to increase the exports of our commodities. The single most important factor in export is Federal policy. We don't raise a single product for 100 percent domestic consumption; without exports, all commodities will be at depression level. Embargoes have given us a very bad name as a world supplier, yet in favor of the State Department, organized labor, or who knows who else, most of our recent Presidents and Congresses have opted to embargo, at the expense of the farmer.

Someone said to me recently, "Sell it to the Russians, give it to the Poles, loan it to the Nigerians." Not too bad logic.

Finally, sir, move cautiously when you legislate money—money would more than likely would fare better if left alone, domestically. When it comes to the Federal Government, however, and this is your bailiwick, it would seem that Congress, the President, or somebody, could get the Government out of the money market when the price gets too high. Two, put much, much effort behind the export of farm products. Remember, the only thing the world is buying from us now, and paying for it, are farm commodities. And three, please don't let the diplomats and the would-be consumer protectors dupe you into supporting, or even allowing, embargos.

Senator SASSER. Thank you, Mr. Moseley. I want to thank both of you for giving us the benefit of your views, and we will see that your statements are delivered to Senator Pryor for his observation and inspection.

Thank you for coming over from Arkansas, and giving us the effect of the impact that the interest rates are having on the farming sector of our economy.

Our last two witnesses are two distinguished members of the Memphis City Council, the Honorable Oscar Edmonds, the ~~chairman~~ of the city council, and a Memphis businessman; and the Honorable Jeff Sanford, also a member of the Memphis City Council and a Memphis businessman, who will give us an outlook on the effect of high interest rates on municipal officials, municipal government, and also on their businesses in this city.

We will start with Chairman Edmonds.

STATEMENT OF HON. OSCAR EDMONDS, CITY COUNCILMAN, MEMPHIS, TENN.

City Council Chairman Edmonds. Thank you, Senator. We certainly appreciate your taking the time to come here to look into this great problem that we have, not just the businessman, but also government agencies.

Senator, as you know, last year I was appointed by President Carter to the Small Business Administration Advisory Committee. We had two very good, very informational meetings that we had disseminated a lot of information from small businesses, the banking industry, the manufacturing industries, and so forth. We were beginning to get some things working. Shortly after the Reagan administration came in, all of the members of that advisory commission that were made up of small business persons from across the United States, received letters from the Reagan administration saying that they were doing away with the Small Business Administration Advisory Committee. So I presumed at that time there was not a lot of hope for the small businessman. And, of course, with the interest rates and some of the other things that have happened with regard to small business. this has been more apparent.

The industries that have been presented here—fortunately, the group of—the last four, I'm involved with three of those. One, the homebuilding industry. I can relate exactly to what Mr. Willis is talking about. The restaurant industry, I can relate directly to that in the supply area. The small businessman today is at a great disadvantage when he discovers that he must expand; he must expand his inventory, he must expand his sales forces, and so forth.

We are, as the name indicates, small. To compete with the large, we've got to go to other sources to get our moneys, and, of cours[illegible] with the interest rates as high as they are today, this is almost an i[illegible]ibility, as indicated by our predecessors.

Government is affected in the same way. We are a form of [illegible] and our moneys come from those people in the small business ind[illegible] Our taxes come from that homebuilder, that home that he is bu[illegible] from the person who buys that home. As their costs go up, the[illegible] goes up, they cannot buy, and thus eliminates the sources that w[illegible] for our money. The basis of our income here in Memphis primarily is the real estate taxes. If we don't have an expansion, a growth, in that industry, certainly we don't have a growth in the taxes that we will receive, thus creating more costs to those who are now paying, due to the fact that we will have to go up on taxes to perform the minimum services that we're having to perform at this time.

I don't want to take all of our time. Councilman Sanford has some further statements that I think he would like to express.

STATEMENT OF HON. JEFF SANFORD, CITY COUNCILMAN, MEMPHIS, TENN.

Councilman SANFORD. Senator, I too want to thank you for coming to Memphis. As Tif Bingham pointed out in his opening remarks, Memphis is a city of small businesses, and problems of small business affect this community probably to a greater degree than many other communities. I guess there is an advantage and a disadvantage of coming last. The advantage is that everything worthwhile has probably already been said; the disadvantage is that one is forced to try to come up with something that hasn't been said. I will be brief and simply relate a couple of experiences from my personal occupation as a small businessman, relative to the negative effect of high interest rates and then relate a couple of examples of the kinds of things, as a public official, I come in contact with from other small businessmen because of these high rates.

I am in a business partnership. I have a partner in Memphis, another living in Dallas, and one living in Houston. Four partners in a business, I suppose, qualifies the business as a small business. Last year, we faced the need to do some physical expansion in our Dallas office, substantial for us as a small business. Whereas, normally we would have gone to the bank to borrow the money, we determined that because of the interest rates last year, we were not comfortable in bank financing. We had only one other alternative, as we reviewed the list of alternatives, that being to finance our capital expansion out of current income. That is all well and good, and some people would suggest that that's a very conservative, proper way to finance things, if you can do it, but the net effect of it was, in this little, small business on people like Jeff Sanford, that all came out of my pocket, and as a result, I didn't have a particularly good year last year. And as a result of that, in my household, et cetera, a lot of things had to be put off.

We are in a sales business, and I've had the experience recently of making the sales but then losing the sales because the factories which produce the goods that I am selling could not supply the goods because they didn't have the inventory. They didn't have the inventory because interest rates were high and they could not afford this year to carry inventory sufficient to cover all possibilities. The losses that we have suffered in that regard, just in the last couple of weeks, relatively speaking, have been very, very substantial.

As a public official, I hear from a lot of small business people, and essentially, in recent months and over the course of the last year, they have called to complain about two things. One is utility rates, and the Senator and I and others have had many discussions about utility rates. But it's an interesting phenomenon, because on the one hand, for example, TVA electric rates have increased many, many fold recently; in part, according to TVA, because their construction costs and capital costs have increased—and, whether they're floating the bonds themselves, or however they're financing their projects, ultimately they are tied to interest rates. When the interest rates are up, the rates are up, and that creates a real problem on small business people in terms of utilities.

As Oscar said, the city of Memphis is confined, primarily, to use of the property tax as a revenue for the financing of the city budget.

That money goes into what I call the "pie" and the problem here, in recent years, is that we sit down at budget time, trying to slice up the same pie—figure out new ways to slice up the same pie. The pie is not growing. The pie cannot grow unless there is economic expansion in this community. The pie cannot grow unless more people are building and occupying property and paying those taxes. That is simply not happening; many of the other speakers addressed that point, but I want you to know that if you could sit in my office, or Oscar's, or any of the councilmen's office for a day or two, you would hear a repetition of complaints, many of which, in source, tie back to high interest rates. It is a most difficult situation.

Senator SASSER. Gentlemen, I want to express my appreciation—to you, Oscar, and to you, Jeff, for coming over here today and sitting as long as you have, and giving us the benefit of your views. We really appreciate it, and I might say, as a practicing politician, to two others who are part-time practicing politicians, another one of the disadvantages of being last is the television cameras.

City Council Chairman EDMONDS. They left?

Senator SASSER. At the part where you're trying to testify.

Councilman SANFORD. We'll get ours tomorrow, Senator.

Senator SASSER. But I do thank you for appearing, and I might just say that one of the problems with high interest rates that you don't hear much about, and Councilman Sanford touched on it, is the cost of Government of high interest rates. When you owe $1 trillion like the Federal Government does, and that interest rate courses up on you 5 or 6 percent, that gets into serious money pretty quickly. And that's exactly what has happened to TVA's debt, with a lot of the borrowing to build nuclear powerplants. The taxpayers are paying for the cost of these high interest rates.

Thank you very much for appearing. I appreciate your coming, and I appreciate your waiting, and I appreciate your letting me enjoy the hospitality here today.

We want to open the floor now. Any interested citizen who would like to give us his or her views for not more than 5 minutes per person on the impact of high interest rates?

If there are none forthcoming, then, I will declare these proceedings here in Memphis closed, and the record of the Committee on Small Business will be held open for several weeks to include other statements that interested citizens might wish to submit for the record.

[Whereupon the hearing adjourned.]

[Additional material follows:]

PLIGHT OF FAMILY BUSINESSES AND FAMILY FARMS UNDER REAGANOMICS

Remarks Submitted for the Record by

Marlin D. Jackson
Chairman and President
Security Bank
Paragould, Arkansas

For more than twenty years I have been actively engaged in community/agricultural banking. Foremost among my responsibilities have been efforts of the banks with which I was associated to extend loans within our trade territory to those seeking credit. Overwhelmingly, the loans are made to what typically are referred to as family businesses, ranches, farms, and agri-business concerns. Our borrowing constitutency is such that they cannot access regional money markets. It would be absurd for them to attempt to gain access to the national credit market.

The recent rate of inflation that has driven interest rates to historic heights has created a situation in which many of the most deserving businessmen/farmers of our community are forced to pay interest rates that lead inevitably to insolvency if not outright bankruptcy, or they are forced to delay urgently needed expenditures. In the last couple of years I have frequently seen owners of many family businesses and many family farms refinance their homes, farms, and businesses on a long-term basis; thus, in effect, giving up the equity they have worked for the last twenty or thirty years to create.

The margins of profit on farming in 1981 are recognized as being among the lowest in modern history. Thus, farmers can ill afford to borrow money for operating purposes or purposes of replacing their farm equipment, buildings, etc.

I know of few family businesses that enjoy profit margins large enough to permit acquisition of the necessary operating capital at the present interest rates of 18-20%. Indeed, the net profits of most businesses in our community run substantially below 10%.

A great deal has been said and volumes have been written, applauding the recent monetary policies that permit the wealthy of the nation to enjoy historic earnings on their accumulated savings.

It is appropriate, indeed essential, that those with savings be provided an environment in which they have a reasonable "real" return on their money in excess of the rate of inflation. Historically, the rate of real return is to run between 1½-3%.

If current figures are accurate, inflation is somewhere in the 10% range. Thus, it would be appropriate for those with savings to garner real returns of 12-13%.

One needs only to glance at the local newspapers, or even placards in the windows of leased offices in main street U.S.A. advertising the Money Market Mutual Funds, to see that yields of 16-17% are readily available.

Thus, the scene is set for the dilemma faced by community banks and by those who are to be served by the community banks.

Community banks traditionally have been the mainstay in financing endeavors of local communities, especially family businesses and farms. Each day we find that we must decline at least three-fourths of the applications we receive because of the probability that our customers will not be able to generate enough profit to repay the loan at interest rates, that would be profitable to the bank.

A serious impediment to commercial banks in Arkansas is the constitutional usury law that unfairly protects the least creditworthy and tends to drive the cost of funds upward on those exempted under Federal Funds, who are more creditworthy.

I suggest that the final verdict on the appropriateness of total deinsulation of interest rates is not in. I contend that there are far more poor people who have legitimate needs to borrow than there are wealthy who benefit the most from present tax and monetary policies.

In the past weeks, on an average of once a day, I have counseled with working husbands and wives, who cannot afford to buy urgently needed homes because of ridiculously high interest rates. The incidence of farmers and family business people who face the same dilemma is far greater than that of the homebuyer.

I respectfully remind you that interest rates are not a symptom of inflation; they are the end product of irresponsible fiscal and monetary policies.

In the past ten years I have observed many individauls who, ten years ago, were deemed to be "comfortably wealthy" reduced to dependence on their family or dependence on the government because of the devastating impact on the accumulated savings.

Last, but most important, it is blatantly unfair for Money Market Mutual Funds to continue to accumulate billions of dollars garnered from every community in the country, without some obligation to look at priority of needs. It is an undisputed fact that these funds are not recycled to the local communities. They wind up in the international finance vis a vis a couple of dozen of the largest money center banks in the world. The banks are not required to file community reinvestment statements, to consider the needs of the community from which the funds are garnered, nor are they required to consider the general welfare of the United States as a whole. It is a well-known fact that many of the recipient depositories of these funds are engaged in highly speculative merger loans of multi-billion dollar amounts. Additionally, these same banks are engaged in loans to Warsaw Pact Treaty Nation, i.e., Poland, and to Bananna Republics whose financial solvency and political stability are suspect, to say the least.

Thank you for permitting a "red neck" country banker to share his views.

Security
Bank
P.O. BOX 670 • PARAGOULD, ARKANSAS 72450
501-239-9571

M. D. JACKSON
CHAIRMAN & PRESIDENT

October 19, 1981

Senator James S. Sasser
405 Russell Senate Office Building
1st & C Streets, N.E.
Washington, D. C. 20510

Dear Senator Sasser:

I am enclosing copies of correspondence and remarks that I hope you and Senator Pryor will consider and include in your hearings of October 19.

I commend you, as well as Senator Pryor for your very legitimate concern over the crisis faced by the rural communities of America.

Thank you for any considerations my views may receive.

Sincerely,

Marlin D. Jackson

MDJ:ji

Security Bank

P.O. BOX 670 • PARAGOULD, ARKANSAS 72450
501-239-9571

M. D. JACKSON
CHAIRMAN & PRESIDENT

October 19, 1981

Senator David Pryor
248 Russell Senate Office Building
Washington, D. C. 20510

Re: Small Business Hearing
October 19, 1981
Memphis, Tennessee

Dear Senator Pryor:

I commend you and Senator Sasser for your interest in the plight of small businesses.

My schedule will not permit me to attend the hearings. However, I would like to submit the enclosed remarks for the record.

Sincerely,

Marlin D. Jackson

MDJ:ji

APPENDIX

NSB
NATIONAL SMALL BUSINESS ASSOCIATION
THE VOICE OF SMALL BUSINESS

September 22, 1981

Hon. Lowell Weicker, Chairman
Senate Committee on Small Business
424 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman,

Since you are just beginning a set of hearings on high interest rates and their relationship to bankruptcies, and economic recovery, I thought you might be interested in the attached report just completed by NSB today.

The report does tend to bear out many of your remarks and those of Senator Nunn contained in your press release of September 18th.

It is evident that there is a direct correlation between high interest rates and bankruptcies. Noteworthy as well, is the effect on business bankruptcies of liberalized personal bankruptcy laws.

Should you find this report to be of assistance in furthering your hearings, please feel free to use it in any way you see fit.

Sincerely,

Jerry Gulan
Jerome R. Gulan
Vice President-Government Affairs

Attachment: Bankruptcy report

c.c. Hon. Sam Nunn
Robert Dotchin
Jim O'Connell
Alan Chvotkin
Tom Cator

LOWELL WEICKER, JR., CONN., CHAIRMAN

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ROBERT J. DOTCHIN, STAFF DIRECTOR
R. MICHAEL HAYNES, CHIEF COUNSEL
ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

October 6, 1981

Mr. Jerome R. Gulan
Vice President
Government Affairs
National Small Business Association
NSB Building, 1604 K Street, N.W.
Washington, D.C. 20006

Dear Jerry:

Thank you for your recent letter and enclosure concerning high interest rates and increased bankruptcies.

I have gone over your report and am very much impressed by the careful research that obviously has gone into it. I have decided to submit it for the interest rate hearing record because I believe it deserves the widest possible circulation.

Thank you again for providing the Committee with this timely paper and for your continued fine work on behalf of small businesses in our country.

Sincerely,

LOWELL WEICKER, JR.
Chairman

REPORT ON BUSINESS BANKRUPTCIES

Prepared by National Small Business Association -- September 21, 1981

Business Failures: Current Statistics

From mid-1980 to mid-1981 court-filed business bankruptcies increased 30.1 percent. This is the second largest year-to-year rise of the past 20 years, below only the 45.2 percent increase occuring between 1974 and 1975.

Even more alarming are more current figures from Dun & Bradstreet for January 1 through September 3, 1981, which reflect that business bankruptcies increased from 7,812 to 11,076, a jump of 41.8 percent compared with the same 35 week period in 1980, according to press reports quoting Rowena Wyant, a D&B Vice President in the New York business economics division ("Business Failures Increase," New York Times, September 13, 1981.)

Smaller businesses (defined as those with liabilities of $100,000 or less) comprised 50.53 percent of the 1981 total.

An industry breakdown of the D&B figures for the 35-week period is as follows:

1981 Compared to 1980	
Construction	up 48.5%
Services	up 47.6%
Retailing	up 41.4%
Manufacturing	up 36.9%
Wholesaling	up 30.1%

This information is probably conservative from the small firm standpoint, because D&B figures do not include the finance, insurance, and real estate fields where smaller businesses predominate.

In a recent newspaper column George Will characterized similar figures as "a massacre on Main Street." (The Massacre on Main-Street ", Washington Post, September 20, 1981, page C8:1)

The court filings are on the basis of the "statistical year" of the U.S. Courts which record the information, which for the past two years has been as follows:

"Statistical year" July 1, 1979 - June 30, 1980 = 36,433
"Statistical year" July 1, 1980 - June 30, 1981 = 47,414

Notes

As a technical matter, it should be noted that courts also accept Joint Petitions. These are additional filings where the husband and wife both participate in the enterprise. These are excluded from the above figures, because a "joint petition" covers persons associated with a business that has already filed. Inclusion of joint petitions would increase the business total for the 1980-81 statistical year to 66,000.

The statistics are also affected by changes in the Bankruptcy laws brought about by the Bankruptcy Reform Act of 1978 (effective October 1, 1979). The new code did not make it easier for corporations to file. The law did establish a series of personal exemptions in Federal law for the first time which, in many instances, were more liberal than state laws. (Bankruptcy Code, Sec. 522). However, there were not and are not any corporate exemptions, and corporations can no longer be discharged of debt as they could under the old law.

Historical Trends

The statistics on bankruptcies since 1950, as collected by both the U.S. Courts and Dun & Bradstreet are set forth in a chronological table attached as Exhibit 1.

The data show that business bankruptcies have risen and fallen in cycles. From mid-1961 through mid-1970, court-filed bankruptcies by businesses held almost constant (averaging about 16,200 per year, or 1350 per month). Then from mid-1971 to mid-1976, the figure more than doubled to 35,201 (about 2900 per month). Thereafter, the level declined until the end of 1979, when it stabilized at about 2,500 per month, as shown in the following table:

Court filed bankruptcies mid-1975 to mid-1980

1975-76	35,201
1976-77	32,189
1977-78	30,528
1978-79	29,500

Within a few months after the Federal Reserve action of October 1979 boosted interest rates to then-record levels, business bankruptcies began to climb dramatically. Totals reached an average of about 3,800 per month in the spring of 1980, where they remained until this year (1981) when they hit a new plateau of about 4,000 per month. This can be seen in the following quarterly tabulations:

	July-September	October-December	January-March	April-June
Statistical Year 1980-81	11,674 ('80)	11,227 ('80)	12,101 ('81)	12,081 ('81)
Statistical Year 1979-80	8,457 ('79)	7,014 ('79)	9,137 ('80)	11,473 ('80)

Thus, the business bankruptcy level increased 63.57 percent from the beginning of October, 1979 to the end of June, 1980.

Particularly Hard-Hit Industries

Some industries are particularly hard hit, such as construction. According to Dun & Bradstreet, bankruptcy rates for building contractors and subcontractors increased 48.5 percent through September 3, 1981 over the same period in 1980 (by which time the casualty figures had already risen substantially from the 1979 lows.)

A break-out of comparable figures for the first three months of this year shows:

Failure in Building and Construction

	January-February-March 1981	January-February-March 1980	Increase #	%
General Building Contractors	282	228	54	23.68
Building Subcontractors	358	218	140	64.22
Other Contractors	45	22	23	104.55
	685	463	222	47.95

Source: Dun & Bradstreet, New York.

In automobile distribution, 1650 new car dealers went out of business in 1980, the largest total ever. Another 325 have failed during the first 6 months of 1981, bringing the overall exodus close to 9 percent of all businesses in this field since 1979 (NADA Data for 1981, National Association of Automobile Dealers).

"Walkaways"

There are also innumerable instances when businesses just close their doors and terminate the business. They may now owe creditors nothing. Or, they may have substantial debts which are satisfied through attachments on bank accounts or foreclosing tax liens or mortgages, leaving few assets for general creditors to pursue in any kind of formal proceeding. There is probably no overall source of statistics on these "walkaways," but experts believe the number is substantial.

Relationship Between Individual Bankruptcies and Business Bankruptcies

Court-filed bankruptcy rates for individuals have more than doubled since the new bankruptcy code became effective in October 1979:

Non-Business Bankruptcies

1978-79	196,976
1979-80	314,856
1980-81	450,000 (preliminary)

These personal bankruptcies have direct ramifications for small business.

When an individual declares bankruptcy, the creditors are left "holding the bag," which is almost always empty.

Prominent among these creditors are the retailers, distributors, builders and service enterprises where the bankrupt ran up the bills which caused the problems. Many of these are small business.

For example, the May Company reported 1980 losses increasing 103.3 percent to $3.6 million compared to 1979. For J.C. Penney, losses increased 102 percent to $20.7 million. Montgomery Wards' losses increased 117 percent to $50.6 million, while Sears' losses increased 120.4 percent to $46.2 million for the same period.

Local businesses have the same kind of trouble. In fact, some of the regional independent stores, which are members of the National Retail Merchants Association, reported 1980 losses increasing over 200 percent compared to 1979.

Relationship Between Interest Rates and Bankruptcies

These cycles raise the question of how interest rates affect bankruptcies. As can be seen from comparing interest rate movements with the bankruptcy cycles documented by Dun & Bradstreet and the U.S. Courts, bankruptcies have tracked the interest rate very closely in recent years. This is illustrated by the chart attached as Exhibit 2, which was prepared by the Small Business Committee of the U.S. House of Representatives.

In technical terms, the correlation between real interest rates (e.g., the nominal rate minus the inflation rate [GNP deflator] was 74.5 percent during the 3-year period coverd by the chart and 73.47 percent for the 5 years from 1976 to 1981. Economists say that 74 percent constitutes a "direct and significant correlation" between these two factors.

Higher interest rate movements can affect a business directly and indirectly in several ways. They add to the costs of financing the production, distribution, inventorying and sale of merchandise. They are also a factor in willingness of consumers to purchase the product.

Interest rates also impact general economic conditions with multiple affects on small firms.

A statistical "correlation" does not spell out how two factors relate to each other or what other factors may be involved. But a correlation does indicate some kind of a relationship -- in lesser or greater degree -- and a correlation as high as 74 percent indicates the relationship is close and meaningful.

The plight of industries composed mostly of small firms which are particularly sensitive to interest rates -- such as builders and auto dealerships -- tend to confirm this relationship.

Thus, as long as interest rates remain at record rates, it can be expected that bankruptcies will also continue to set new records.

Effects on Employment

The fifteen million small firms in the U.S. which file tax returns account for 55 percent of existing employment (59 percent if farming is included) and aproximately 80 percent of all new jobs. Professor David Birch of M.I.T. found that independent enterprises with 20 or fewer employees accounted for 52 percent of net new private sector jobs between 1967 and 1976. Thus, as bankrupticies increase among small firms, job generation may be inhibited, existing jobs threatened, and increased unemployment may result.

Since each one percent increase in the unemployment rate (approximately equal to one million persons) deprives the U.S. Treasury of $25 to $29 billion in tax revenues foregone and benefits paid, increased bankruptcies -- especially among small businesses -- can translate into larger budgetary and economic problems.

The Human Dimension of Bankruptcies

Several years ago, a doctor at Johns Hopkins University researched the social effects of unemployment ("Estimating the Social Costs of National Economic Policy: Complications for Mental and Physical Health" by Professor Harvey Brenner, Joint Economic Committee Print, October 26, 1976).

This study found that during periods of higher unemployment , use of alcohol hospitalization, suicides, heart attack and kidney disease also showed statistical increases.

Such an analysis could apply not only to employees, but to small business owners. Entrepreneurs would also be subject to great financial and personal stress in attempting to save businesses in which they have invested a significant amount of their savings and their careers, especially if these efforts were unsucessful.

According to an attorney who has practiced bankruptcy law for 42 years, Samuel Greenbaum of Washington D.C., many small businesses are under-capitalized to begin with. As a result, such owners are often required to put up personal assets such as their homes as additional security for business loans. If a bankruptcy follows, an owner can also have his family life shattered, exacting a "toll of personal tragedy".

The surge in business failures is therefore of great concern for both economic and social reasons.

###

Exhibit 1

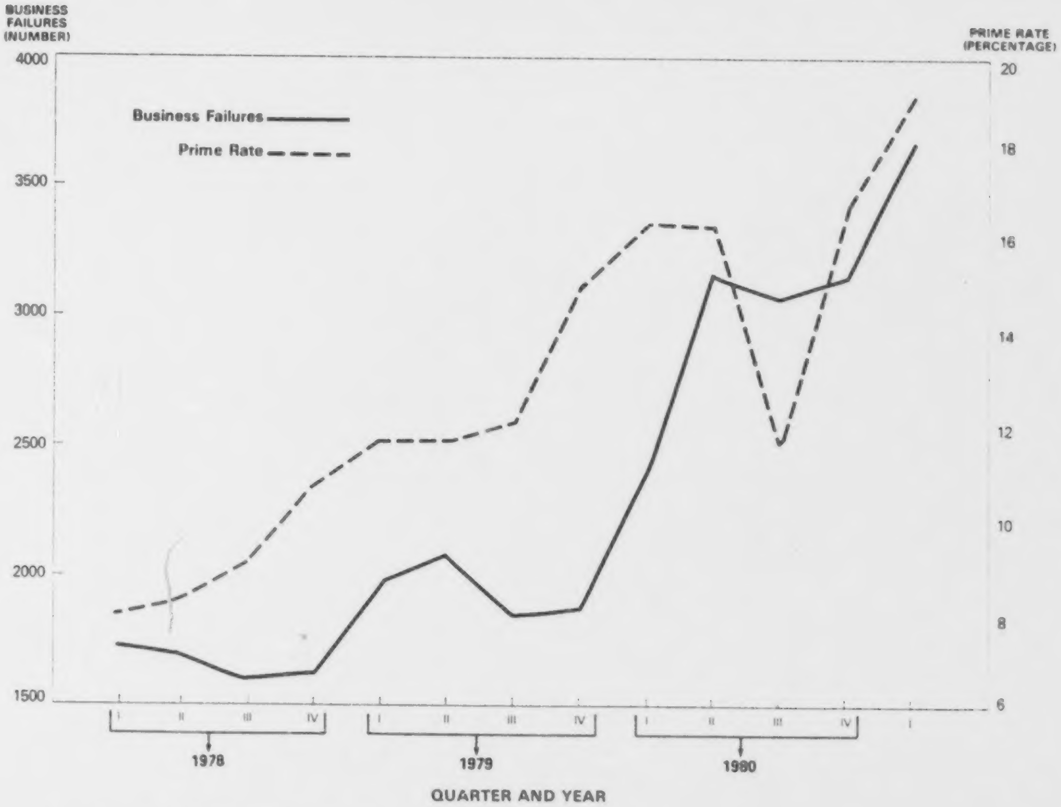
BUSINESS FAILURES

According to U.S. Courts	
1950	8,352
1951	7,387
1952	6,542
1953	6,772
1954	8,888
1955	9,185
1956	9,478
1957	10,144
1958	11,403
1959	11,729
1960	12,284
1961	15,241
1962	15,665
1963	16,303
1964	16,510
1965	16,910
1966	16,430
1967	16,600
1968	16,545
1969	15,430
1970	16,197
1971	19,103
1972	18,132
1973	17,490
1974	20,747
1975	30,130
1976	35,201
1977	32,189
1978	30,528
1979	29,500*
1980	36,443*
1981	47,414*

According to Dun & Bradstreet	
1950	9,162
1951	8,058
1952	7,611
1953	8,862
1954	11,068
1955	10,969
1956	12,686
1957	13,739
1958	14,964
1959	14,053
1960	15,445
1961	17,075
1962	15,782
1963	14,374
1964	13,501
1965	13,514
1966	13,061
1967	12,364
1968	9,363
1969	9,154
1970	10,748
1971	10,326
1972	9,566
1973	9,345
1974	9,915
1975	11,432
1976	9,628
1977	7,919
1978	6,619
1979	7,564
1980	11,742
1981(thur Sept. 3)	11,076

* Exclusive of Joint Petitions

BUSINESS FAILURES AND PRIME RATE



SOURCES FEDERAL RESERVE BULLETIN, DUN & BRADSTREET

STATEMENT
BY RAY MACKEY, PRESIDENT
KENTUCKY FARM BUREAU FEDERATION
TO THE
SELECT COMMITTEE ON SMALL BUSINESS,
UNITED STATES SENATE
SEPTEMBER 23, 1981

STUBBORNLY HIGH INTEREST RATES ARE QUITE LIKELY THE MOST DAMAGING SINGLE ASPECT OF CURRENT ECONOMIC CONDITIONS FACING FARMERS. MOST FARM CREDIT FOR THIS YEAR'S CROP CAME VERY DEAR TO KENTUCKY FARMERS, AND THOSE CREDIT COSTS WERE RESPONSIBLE FOR SOME VERY PROFOUND AND TROUBLING CHANGES IN FARM OPERATING PROCEDURES.

THE MOST OBVIOUS IMPACT OF HIGH INTEREST RATES ON AGRICULTURE IS ON COST OF PRODUCTION. THE UNIVERSITY OF KENTUCKY SAYS THAT EACH PERCENTAGE POINT INCREASE IN INTEREST CHARGES RAISES PRODUCTION COSTS FOR KENTUCKY CROPS AND LIVESTOCK IN THE FOLLOWING AMOUNTS:

* TOBACCO- 1 CENT PER POUND
* CORN- 1½ - 2 CENTS PER BUSHEL
* SOYBEANS- 3 - 4 CENTS PER BUSHEL
* MILK- 8 - 10 CENTS PER HUNDRED
* FEEDER CALVES- 40 - 50 CENTS PER HUNDRED

WHEN THESE FIGURES ARE TRANSLATED INTO REDUCED NET PROFIT MARGINS, WHICH FOR FARM COMMODITIES ARE NORMALLY QUITE SMALL, THEIR IMPACT CAN BE SUBSTANTIAL. THE U.S. DEPARTMENT OF AGRICULTURE ESTIMATES THAT EACH POINT INCREASE IN INTEREST COSTS REDUCES NET FARM PROFIT FROM 5 TO 10 PER CENT. WITH TODAY'S DEPRESSED MARKET PRICES FOR MANY COMMODITIES, THE IMPACT IS PROBABLY TOWARD THE UPPER END OF THE RANGE. INTEREST RATES FOR MUCH OF THE CURRENT CROP YEAR HAVE BEEN AT OR ABOVE 17 PER CENT, WITH SOME SHORT-TERM LOAN CHARGES OVER THE 20 PER CENT MARK. ASSUMING THAT 12 PER CENT INTEREST IS NOW NORMAL, AN ASSUMPTION THAT WOULD NOT HAVE BEEN CONSIDERED ACCEPTABLE EVEN A YEAR AGO, FARMERS HAVE ENDURED AT LEAST 5 ADDITIONAL POINTS OF INTEREST THIS CROP YEAR. THOSE 5 POINTS, ASSUMING THEIR IMPACT ON PROFIT MARGINS TO BE NEAR THE 10 PER CENT LEVEL EACH, WOULD HAVE WIPED OUT AROUND HALF OF EACH FARMER'S NET PROFIT. AND WITH CONTINUED INFLATION IN THE AREA OF OTHER CROP INPUTS, THOSE BORROWING COSTS WERE A DEVASTATING BLOW.

PRODUCTION COSTS, HOWEVER, ARE NOT THE ONLY WAY THAT CREDIT COSTS WORK TO THE DETRIMENT OF AGRICULTURE. NEWS STORIES IN RECENT WEEKS HAVE PAINTED A BLEAK PICTURE FOR THE FARM MACHINERY INDUSTRY. PLANT SHUTDOWNS AND LAYOFFS BY MANUFACTURERS AND THE CLOSING OF DEALERSHIPS ARE THE MOST VISIBLE RESULT OF FARMERS' INABILITY TO UPGRADE OR MODERNIZE THEIR MACHINERY. MAKING DO WITH OLDER MACHINES WILL SUFFICE FOR A WHILE, BUT EVENTUALLY WILL ERODE FARM PRODUCTIVITY. SIMILARLY, FARMERS' PLANS TO BUY ADDITIONAL FARMLAND ARE BEING DELAYED. USDA TELLS US IT NOW TAKES THE EARNINGS FROM FOUR ACRES OF FARMLAND JUST TO PAY THE INTEREST ON THE PURCHASE PRICE OF ONE ADDITIONAL ACRE.

Such figures mean stagnation for existing producers, but even worse, they effectively close the door to young people wishing to begin an agricultural career.

High credit costs also reduce or eliminate marketing flexibility for most farmers. The combination this year of bumper crops, transportation bottlenecks, uncertain foreign trade prospects and prohibitive credit costs is a four-way stop sign to grain producers. Many farmers will be forced to sell all or part of their crop at harvest, the worst possible time to command a fair price. But a decision to hold a crop would be little more than a suicide squeeze play, gambling against the odds that price improvement will match or exceed the staggering carrying charges.

There is strong evidence that the current extended period of high interest rates is about to catch up with even the most financially stable farmers. Unusually high numbers of farmers have refinanced short and intermediate term debts, agreeing to extended repayment periods in hopes of riding out the current cycle. Farm Credit System officials say a full one-third of this year's loan volume in Kentucky is for purposes of refinancing. Farmers are obviously parlaying their current cash flow problems, hoping against hope that conditions will improve. Further long-term delays in economic improvement could bring the walls of economic viability crashing down around them.

WITH THIS GLOOMY FARM FINANCIAL SCENARIO IN MIND, IT'S EASY TO SEE THAT FARMERS SHARE THE FRUSTRATION FELT BY OTHER SECTORS OVER THE HIGH INTEREST RATES. ON THE FARM AND IN THE CITY, THE CLOCK IS THE ARCH-ENEMY OF THOSE TRYING TO HOLD ON UNTIL THE COST OF BORROWED CAPITAL COMES DOWN. FARMERS' PATIENCE IS WEARING THIN.

THE IMPATIENCE, HOWEVER, DOES NOT TRANSLATE INTO A CALL FOR SOME SORT OF ILL-ADVISED GOVERNMENTAL INTERVENTION, OR AN ARTIFICIAL CEILING TO GIVE AMERICANS A FALSE SENSE OF SECURITY ON THE ECONOMY. THE LAST THING WE NEED RIGHT NOW IS ARBITRARY GOVERNMENTAL TINKERING TO BRING DOWN INTEREST RATES WITHOUT CURING THE CONDITIONS WHICH HAVE CAUSED HIGH INTEREST RATES.

THOSE CAUSES, WE BELIEVE, ARE TWOFOLD: FIRST, WE BLAME THE THREE DECADES OF MASSIVE SPENDING BY THE FEDERAL GOVERNMENT, WHICH PRODUCED DISASTROUS INFLATION AND MAMMOTH DEFICITS. BORROWING BY THE FED TO COVER THE DEFICITS NOW USES UP MORE THAN ONE-FOURTH OF ALL THE CAPITAL AVAILABLE TO INDIVIDUAL AND BUSINESS BORROWERS. THAT DEBT SERVICE BY THE FEDERAL GOVERNMENT IS EXPECTED TO TOTAL 90 BILLION DOLLARS IN 1982. INDIVIDUALS AND BUSINESSES ARE LEFT TO FIGHT EACH OTHER FOR THE REMAINING CREDIT DOLLARS AFTER THE FEDERAL GOVERNMENT TAKES ITS HUGE SHARE. IN REALITY, THE FED USES OUR TAX MONEY TO BID UP THE COST OF OUR CREDIT. CREDIT IS THUS DIVERTED FROM PRODUCTIVE FARM OR BUSINESS USES TO FINANCE THE ACTIVITIES OF THE NON-PRODUCING GOVERNMENTAL SECTOR.

SECONDLY, WE BELIEVE THAT INTEREST RATES ARE STAYING UP IN RESPONSE TO FEARS BY THOSE IN THE FINANCIAL COMMUNITY THAT THE ADMINISTRATION AND CONGRESS WILL NOT HAVE THE POLITICAL COURAGE TO MANDATE THE ADDITIONAL BUDGET CUTS REQUIRED TO BALANCE THE FEDERAL BUDGET WITHIN THE NEXT TWO YEARS. THESE FINANCIAL LEADERS SEE THAT FURTHER BUDGETARY CUTS TOTALING NEARLY $300 BILLION WILL HAVE TO BE IMPLEMENTED DURING FISCAL YEARS 1982, '83 AND '84 TO CLOSE THE GAP BETWEEN FEDERAL REVENUES AND FEDERAL EXPENDITURES. THESE CUTS ARE IN ADDITION TO THOSE ALREADY APPROVED BY CONGRESS LAST MONTH. WITHOUT THE CUTS, EVEN LARGER DEFICITS WILL BE EXPERIENCED, REQUIRING FURTHER SIPHONING OFF OF INVESTMENT CAPITAL TO THE FEDERAL GOVERNMENT.

THE ONLY SATISFACTORY SOLUTION TO HIGH INTEREST RATES, IN OUR OPINION, IS FOR CONGRESS TO AGAIN BITE THE BULLET AND BRING FEDERAL EXPENDITURES DOWN IN RELATION TO THE REST OF THE ECONOMY. THIS YEAR, FEDERAL SPENDING WILL TOTAL OVER 23 PER CENT OF THE GROSS NATIONAL PRODUCT, WHICH REFLECTS ALL THE ECONOMIC ACTIVITY OF THE NATION. THIS PERCENTAGE COMPARES VERY UNFAVORABLY WITH THE FIGURES COMPILED IN THE PERIOD 1955-57, WHEN SPENDING BY THE FED AMOUNTED TO ONLY 17 PER CENT OF GNP.

INDEXED ENTITLEMENT PROGRAMS HAVE BEEN SIDESTEPPED IN PREVIOUS BUDGET CUTTING EFFORTS, BUT MUST NOT BE OVERLOOKED AGAIN. SUCH PENSION, HEALTH AND SOCIAL SERVICE PROGRAMS ARE EATING UP INCREASINGLY LARGE CHUNKS OF THE BUDGET, AND NO SINCERE EFFORT TO CURTAIL SPENDING CAN OMIT THIS CATEGORY OF APPROPRIATIONS.

WE IN FARM BUREAU ARE CONVINCED THAT QUICK AND RESPONSIBLE ACTION TO FURTHER REDUCE FEDERAL SPENDING WILL, OVER THE LONG TERM, TAKE THE PRESSURE OFF THE NATION'S MONEY SUPPLY AND ALLOW INTEREST RATES TO RESUME THEIR HISTORICAL POSITION-- SOMEWHERE AROUND 2 OR 3 PER CENTAGE POINTS OVER THE INFLATION RATE. WE ESPECIALLY DEPLORE ANY ATTEMPT TO CHARACTERIZE CURRENT INTEREST RATES AS EVIDENCE OF THE "FAILURE" OF PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAM. WE SUPPORT ALL FOUR POINTS OF THE PRESIDENT'S PLAN TO REVITALIZE THE ECONOMY AND SINCERELY BELIEVE IT IS THE ONLY WAY TO RETURN THE NATION TO TRUE PROSPERITY.

SINCE THE PRESIDENT'S TAXING AND BUDGETARY REDUCTIONS DO NOT GO INTO EFFECT UNTIL NEXT MONTH, IT IS NONSENSICAL TO ATTACK THOSE REDUCTIONS AS THE CAUSE OF OUR CURRENT PROBLEMS WITH INTEREST RATES. CONVERSELY, THE INTEREST RATES ARE THE BEST ARGUMENTS FOR THE PRESIDENT'S PROGRAM, SINCE THE COST OF BORROWING IS DETERMINED PRIMARILY BY THE RELATIONSHIP BETWEEN LOAN DEMAND AND SUPPLY OF CAPITAL. IN THE FUTURE, REDUCED SPENDING WILL MEAN LESS COMPETITION FROM THE FED IN THE MONEY MARKETS, WHILE REDUCED TAXATION WILL STIMULATE INCREASED PERSONAL SAVINGS AND INVESTMENTS, PROVIDING MORE MONEY FOR CREDIT NEEDS.

President Reagan has given the nation the blueprint for economic recovery, and Congress has assumed a partnership role in carrying out this program. Farm Bureau commends Congress and the Administration for its bipartisan approach to economic recovery. We are convinced that this method offers the best hope for permanent resolution of our complex fiscal dilemma. We urge this committee to use its every means to further strengthen the nation's economic prognosis.

Economic remedies are commonly sought through government, but seldom found in government. The only true economic remedy lies with the individual wage earners, farmers and business people. The burden of support for a massive and non-productive federal government has, during the past several decades, sapped the financial vitality of the private sector. As this burden is relieved, economic strength will gradually return. President Reagan has shown the way. We urge you to do all you can to build on his corrective framework and to give his program time to work.

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National
Farmers Union

STATEMENT OF

ROBERT J. MULLINS
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

PRESENTED TO THE
COMMITTEE ON SMALL BUSINESS
U.S. SENATE

CONCERNING
THE IMPACT OF HIGH INTEREST RATES
ON SMALL BUSINESS AND ON FUTURE
CREDIT NEEDS

Washington, D.C.
September 23, 1981

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Chairman Weicker and Members of the Committee:

I am Robert J. Mullins, Director of Legislative Services for the National Farmers Union. We commend you for conducting this hearing on a problem of deepening concern to farmers, a major segment of small business in Rural America.

Before presenting our analysis of the impact of currently extraordinarily high interest rates on agriculture and food production and on the future credit needs, it is important to note that Congress has recognized agriculture as small business and made farming units eligible for Small Business Administration loans and assistance.

Public Law 94-305, The Small Business Act and Small Business Investment Act Amendments of 1976, establishes a new subsection (b) in Section 2 of the Small Business Act, reading as follows:

"It is the declared policy of the Congress that the Government through the Small Business Administration, should aid and assist small business concerns which are engaged in the production of food and fiber, ranching, and raising of livestock, aquaculture, and all other farming and agricultural related industries; and the financial assistance programs authorized by this Act are also to be used to assist such concerns."

Sections 3, 7 (a), 7 (b) and 18 of the Small Business Act are also amended to bring farming and agricultural related industries under the Act.

Although the Consolidated Farm and Rural Development Act of 1980, Public Law 96-302, assigned the major responsibility for agricultural disaster lending to the USDA/FmHA, the 1980 legislation did not affect the basic recognition of agriculture as small business.

Virtually all of the 2.4 million farming units would qualify as small business --- only about 150,000 would have gross receipts exceeding $100,000 a year. That would be less than 7% of the total number of farming units.

Size standards and definitions of commercial business vary by agency. According to the Census Bureau count, there are about 5.2 million small nonfarm businesses.

These account for about 48% of the Gross National Product (GNP) and slightly more than half of the total U.S. employment.

More significantly, as your committee has pointed out from time to time, virtually all of the new job creation in the national economy takes place in the small business sector. The "FORTUNE 500" list of corporations accounts for very little, if any, creation of net new jobs.

As you have said yourself, Mr. Chairman, "to a major extent, plans for national economic recovery rest on the future strength and financial health of the small businesses that make up our nation."

In regard to the impact of interest rates on business and agriculture, major business corporations have some ability to insulate themselves from the punishing effects in that they are somewhat able to generate capital internally. But this is not generally possible for small business and only to a decreasing extent possible in farming.

According to the USDA Economic Research Service, in 1970 farmers depended upon borrowing for only 5.2% of their cash sources of funds. That proportion jumped to 16% with the acceleration of interest rates in 1977, to 20% in 1980 and will be about 23% for 1981.

It now appears likely that interest outlays by farmers in 1981 will exceed $20 billion and that this will represent about 14% of total production outlays. Worse than that, it may even exceed total net income for the year which may drop below $20 billion.

The net effect is that as farmers borrow more and pay higher interest rates, sagging net farm income puts them in a position where they have sharply less ability to repay the loans.

That is why last week's action of the U.S. Senate in approving a farm bill, which weakens farm commodity support levels and target prices, was a tragically misguided and mistaken action.

According to the most recent Federal Reserve Board Bulletin, the average interest rate paid by farmers for livestock purchases in May, 1981, was 18.44% and for all types of farm loans was 17.88%, about four full points higher than a year ago, an increase of over 25% in the going interest rates.

At a Senate Agriculture panel in June on the "Impact of Credit Policies on American Agriculture," George W. Stone, President of the National Farmers Union, listed these ten ways in which high interest rates have a destructive effect upon agriculture:

-- FARM INTEREST OUTLAYS. Farmers will pay more than $20 billion in interest in 1981 on their current debt of $180.5 billion compared with their outlays of $16.5 billion in 1980.

-- CCC LOAN RATE COSTS. The current CCC interest rate on commodity loans is 14½%. At the existing 1981 crop loan rates, that is a cost to farmers of 46.40¢ a bushel on wheat and 34.80¢ a bushel on corn for 1981 regular loans. If the first year waiver of interest is terminated on farmer-held reserve loans, it will cost farmers 50.75¢ a bushel on wheat and 36.98¢ a bushel on corn.

-- REDUCED PROSPECTS FOR GRAIN EXPORTS. At the start of this year, it was predicted that U.S. farm exports would set a new record value of $48.5 billion in 1981. Now, because high interest rates affect the cost of handling grain inventories and due to other factors, predictions are that exports will have a value of only about $46 billion.

-- NO REDUCTION IN CREDIT USE. High interest rates are a crude and ineffective way of discouraging credit use, at least as far as farmers are concerned. At the end of March this year, farmer borrowings from major commercial banks was running 10% higher than a year ago, at a rate of $5.4 billion in loans per week, compared to $4.9 billion a year earlier.

-- INFLATION RATE IS ACCELERATED BY HIGH INTEREST RATES. Since high interest rates become wrapped up into costs of all industrial and consumer goods and services, they tend to aggravate inflationary pressures, rather than reduce them.

-- COST OF GOVERNMENT SHARPLY INCREASED. High interest rates inflate the cost of government at all levels. For the federal government alone, interest outlays for fiscal year 1982 will be $106.5 billion, up from $94 billion. The interest outlays in fiscal 1982 will be $65 billion higher than in 1977 when the basic cost of money was about 6%.

-- GOVERNMENTAL DEFICITS ARE AGGRAVATED. The $65 billion cited above would be enough by itself to bring the fiscal 1982 federal budget into balance. It is a waste which should no longer be tolerated.

-- ABILITY OF FARMERS TO GENERATE CAPITAL INTERNALLY IS REDUCED. In the year of 1970, U.S. farmers relied on new loans, or a net increase in loans, for only 5% of the cash sources of funds for their operations.

In 1981, farmers are substituting credit for income at an alarming rate, with borrowing accounting for 23% of their cash sources of operating funds.

-- PURCHASING POWER OF CONSUMERS DIVERTED FROM FOOD, OTHER NECESSITIES. The tripling of effective interest rates since 1977 on consumer loans has diverted $30 billion of purchasing power from food, housing and other necessities. Indirectly, therefore, high interest rates depress the effective demand for products of American farms.

-- COMPETITION FOR FUNDS SIPHONS MONEY AWAY FROM THE FARM SECTOR. With the advent of high interest rates has come a proliferation of money market funds and other investment opportunities which are drawing several billion in loanable funds from agricultural purposes. The adverse effect upon country banks, which normally service farm borrowers, has been particularly notable.

Farmers' use of credit is not a discretionary thing. There are few alternatives to debt financing and most of them are undesirable.

The high interest rate crisis will create pressures to increase the leasing of land and equipment, but the cost of leasing may not be much, if any, more advantageous than 100% financing.

High interest rates may also pressure farmers to seek equity capital from outside the farm sector, but this may shift control of farm land out of the hands of the operating farmer. At the extreme, this will make the farm operator a share-cropper on the land.

In the call for this hearing, the question is raised in regard to future credit needs as they may be affected by credit and interest rate policy.

The Congress made an important decision when it created the All-Savers Certificate program in the 1981 Tax Reduction bill. It was significant that agricultural loans were included along with housing loans in the uses for which proceeds of these certificates are to be used, as recommended by the Farmers Union.

This will be of some immediate help, but it is only a one-year program, and it is not possible to estimate at the moment what share of the proceeds will eventually become available to farm operators.

A more important degree of assistance would occur if the Congress would extend the Economic Emergency Loan Program, authorized under the Emergency Credit Adjustment Act of 1978 (Public Law 95-334), which is due to expire on September 30.

Under this program, some 115,000 farm operators were able to obtain last resort loans enabling them to continue in production. Through June of this year, a total of $6.3 billion in such loans had been advanced.

The U.S. House, in its version of the 1981 farm bill, H.R. 3603, contains a provision extending the Economic Emergency Loan Program, but fails to add any additional loan authority. Since only about $400 million in unobligated funds remains, this will not permit future assistance to many farmers if the economic emergency loan program is extended. Farmers Union has proposed an additional $4 billion in loan authority.

Far more significant to farmers and small businessmen would be a decision by the Executive Branch to use the authority available under Title II of Public Law 91-151, the Emergency Credit Control Act of 1969, by which the President can direct the Federal Reserve Banking system to take certain actions to limit and regulate the extension of credit, to set interest rates and to allocate credit to productive uses, such as housing, agriculture and small business.

One may not desire credit controls or credit allocation, but the alternatives are absolutely intolerable -- runaway inflation, recession, high unemployment and hardship for those at the dawn of life, in the twilight of life, or in the shadows of life, the disadvantaged, the handicapped and the poor.

The Carter Administration made a half-hearted attempt at use of the 1969 Act, but abandoned the effort within a couple of months, without ever using the allocation authority.

In conclusion, we direct your attention to the USDA Agricultural Finance Review, July 1981, which contains a lead article, "AN OVERVIEW OF FARM SECTOR CAPITAL AND CREDIT NEEDS," by Dean W. Hughes, staff economist with the Federal Reserve Bank of Kansas City. His conclusion is summed up as follows:

"Farmers' financial condition in the Eighties will be determined primarily by Government fiscal and monetary policies. Net farm income and farmers' wealth may increase substantially if inflation can be controlled and steady growth in real output sustained. If, however, the general economy suffers from high inflation and slow-to-negative growth in output, farmers will probably face financial difficulties by the end of the decade. Farm debt will likely increase (from $182.5 billion) to about $500 billion by the end of the decade with a healthy general economy; it may rise to almost $1 trillion under poor economic conditions."

Under the worst of the economic scenarios examined by Hughes, he concludes that the debt to asset ratio now 18.5% could rise to 27% by 1990; that interest outlays on farm debt could go to $35 billion a year; and that total U.S. net farm income could drop to $6.4 billion a year.

"Since farm production costs continue to rise at a rate approximately equal to inflation, net farm incomes in both nominal and real terms decline to almost nothing in the last half of the decade," Hughes concludes, if a healthy economy is not attained.

THE LAST WORD

By Dick Lehnert

High interest rates: Biggest threat to family farms

When President Ronald Reagan poured out his dream for a revitalized American economy, the image that he conjured in our minds was that, finally, the productive fraction of the population would get it's due.

The assumption was, there are two kinds of people — those who work and those who don't. Reagan it seemed, had those welfare cheats and parasitic "make work" bureaucrats firmly in his gunsights.

But there's "a third group" of people, and it's hard to say whether they work or whether they don't. They're corporation people. Their job is to merge, to conglomerate, to build chains and empires. They build pyramids.

The Egyptians built pyramids. People today still argue just what useful purpose pyramids serve. All agree that a massive amount of energy and talent was expended to build structures that house dead people or sharpen razor blades or whatever else pyramids might be useful for.

It is time we take a hard look at our own pyramid builders and evaluate whether it's good for society that these structures be built. Is there any arguable good that comes from concentration of economic power and wealth? Whatever good there is seems immeasurably offset by evil, and I believe it could and should be stopped.

Corporations are not people and the "interests" of corporations should not be considered to have validity equal to those of people. Their activities should be subject to greater scrutiny and to greater restriction than individual human activities, particularly if it seems the goals of corporations are not in the interests of an open, free, competitive society.

The urge to merge

On the Monday Reagan last spoke on television, urging popular support for his economic plans, I started the day with breakfast with four representatives of the National Farmers Union. Bob Mullins, NFU's lobbyist in Washington, had spent a long weekend in Michigan meeting NFU members at their summer picnic at School Section Lake in Mecosta County. Dick Grabemeyer, former head of ASCS and NFU's new state lobbyist, was there too.

NFU has not been an ardent supporter of Reaganomics, and Mullins was spreading the message that, unless interest rates could be controlled, the ordinary family farmer was doomed.

"High interest rates lead to further accumulation and concentration of wealth," Mullins said. "Money is available to conglomerate companies, but it's not available for productive purposes."

Back in my office, I picked up the *Wall Street Journal*. Reading page 3, it was clear what Mullins was talking about. There was an article on high interest rates, and beside it was an article about the battle for the takeover of Conoco, a highly profitable oil company.

DuPont Co., the Delaware-based chemical company, had put together a $6 billion line of credit, the biggest in history, at 21% interest, the highest in history, to finance the takeover move. Four other firms were wooing Conoco to "come, be part of us."

If that acquisition takes place, it will not lead to the creation of one more productive job or any more product than is currently being produced. Yet the consumers of products produced by that new conglomerate will pay more than a billion dollars more a year just to pay the interest on the borrowed money.

I listened to Reagan's talk on TV that night and there were two words conspicuous by their absence: interest rates. Reagan talked soulfully about how 80% of the nation's businesses were small businesses, and how important they are in the creation of new jobs and new products, and how important it is to them to have adequate capital available, and how the little folks need to be encouraged to save money and invest money. It all sounded rather hollow after my day's activities.

Why change structure?

There has never been a time in my life when American agriculture wasn't under pressure. Some economists say there was never a time in American history when it wasn't under pressure. There has always been too much product and too little price.

Farmers for years have made this threat: "If something doesn't happen, farmers aren't going to produce food anymore." That is absurd. Low profits or high, food comes churning out of the system.

National Farmers Union has a history of high regard for family-style agriculture. One of the reasons NFU advocates "creative government intervention" in agriculture is because it realizes that low-profit systems lead to structural change. In other words, the food supply is going to stay, but the family farmer is going to go.

The family farm will be lost, not because it is not productive and efficient and a valuable part of American life, but because it is not profitable.

High interest rates

High interest rates, and the fact that they allocate credit to "good risks" like DuPont and away from "high risks" like farmers and especially young farmers, are an immediate and visible symptom of an on-going American problem. Everything is being merged and conglomerated and taken over.

In that sense, the NFU's lobbyist Mullins was only urging an alleviation of a symptom. The government, he said, has the power to lower interest rates and to allocate money to any economic sector it wishes. That power was created by the Emergency Credit Allocation Act of 1969. All that is required is to look at high interest rates as an emergency for agriculture.

But the mood of the Reagan administration, and especially of OMB director Dave Stockman, is, "If you can't survive, get out. We're not going to subsidize any weaklings."

The key question is, weak compared to what?

Is it you versus your "less efficient" neighbor? Or is it you versus DuPont?

It is not just farmers. The money is being sucked from our economy (as the high interest rates attest) by the big corporate interests. It is being taken away from all small businessmen, would-be homeowners and many more who could make constructive use of credit. The big companies merely outbid us for it, strictly because they have a "structural advantage." ■

STATEMENT OF BRYCE GRIFFIS, PRESIDENT, STURGIS LUMBER CO., STURGIS, MISS.

MR. CHAIRMAN AND MEMBERS OF THIS COMMITTEE:

My name is Bryce Griffis and I am President of Sturgis Lumber Company, Inc. in Sturgis, Mississippi. I currently serve as President of the Southeastern Lumber Manufactuters Association (SLMA) and am Immediate Past Chairman of that organization's Governmental Affairs Committee. SLMA is headquartered in Forest Park, Georgia and was founded in 1962 by a group of independent small business lumber manufactuers for the purpose of solving industry-wide problems. It currently has an active membership of about 400 small business lumber manufacturers located in 12 Southern States, making it the largest regional association of its kind in the nation. The combined production of our member mills is approximately three billion board feet annually.

Mr. Chairman, I first wish to express our appreciation for the opportunity to submit a statement to your Committee concerning how record high interest rates are affecting the small business community.

As is well known, high interest rates are having a devastating effect on certain sectors of the economy. The lumber manufacturing industry is one of those sectors. It is on the verge of collapse and the reason is simple -- excessively high interest rates. Despite repeated promises from national policymakers and assurances from economists, interest rates have gone higher, not lower. As a result, the timber industry is flat on its back.

Further, there is little evidence that the industry's predicament will improve.

I would like to put that predicament in a factual perspective. My company, Sturgis Lumber, is representative of the typical lumber manufacturer in the Southeast. In the last year, its sales have plummeted 15 percent, while costs have increased 15 percent. Our shipments are 20 percent below the 1979 level, when we had a good year. New orders today are down 40 percent from 1979, and headed lower. As a consequence, we will be forced to lay off 40 of our 90 employees in the next two or three weeks. This will be the first lay-off in the 28 years that I have been in business.

Other SLMA members are experiencing similar problem. As of October 2, 1981, 42 SLMA mills provided the association with a 12-month comparative analysis of their own operations. Their aggragated numbers show that in the last year lumber production is down 23 percent and shipments have declined by 28 percent. Just two weeks ago, that is the week of September 21, SLMA companies laid off 253 employees and four of our members completely shut down their operations. I should add that more larger producers have temporarily ceased operating than smaller firms. The reason is larger companies are much less reticent to terminate employees than are SLMA companies whose owners and managers personally know most, if not all, of their employees and their families. A small producer simply hates to let his people go, so much so that some of our members have gone into bankruptcy attempting to keep their personnel employed full time.

Since the beginning of this year, 53 companies have terminated their SLMA membership due to economic reasons. Fifteen of those former members have gone out of business and ten were acquired by giant forest product companies which enabled the small business owners to salvage something from their operations.

This poor performance can entirely be attributed to high interest rates and their debilitating effect on demand for lumber. If allowed to persist these exorbitant interest rates will cause irreparable harm to the industry and the economy.

While it is easy to identify high interest rates as the most pressing problem facing the timber industry, it is difficult to explain why they have stayed so high. It is even more difficult to say what should be done to bring them down.

Four principal factors appear to affect interest rates: trends in business activity; actions by the Federal Reserve Board; inflation, including expectations; and the federal deficit. None of these factors alone provide the answer, but together they begin to provide an explanation of why interest rates have remained so intransigent.

First, the notion that interest rates and business activity move together makes a lot of sense and requires little explanation. One would expect interest rates, the price of funds, to be low when business financing needs are depressed and high when those needs are increasing. Yet in the second quarter of 1981, economic activity declined and business loan demand increased by more than 9 percent. I know that the timber industry did not contribute to that. What appears to be happening, as Senator Sam Nunn has said, is the creation of a "dual economy." Certain businesses, for example, the timber industry and the automobile industry, are being crushed by high interest rates and are suffering through a depression, not a recession.

Other businesses, for example oil well drillers and defense-related industries, are experiencing a boom and have maintained a heavy demand for credit.

Further complicating this is what appears to be a desire of major corporations to finance their needs in short-term credit markets rather than offering bonds paying 17 percent interest. Certainly those companies cannot be blamed for making sound business decisions.

This increased demand for credit must be juxtaposed with the tight monetary policy of the Federal Reserve Board. That combination necessarily implies high interest rates. But it appears that the Fed is caught in a "catch 22" situation where if it relents, inflationary expectations will flair thus escalating interest rates, and if it continues, interest rates will remain high until there is a more general economic slowdown and a more broad-based decrease in credit demand.

This brings me to the federal deficit. Week in and week out, the financial markets appear to be watching for a continued, steady pace of slow growth in the money supply and for a reduced deficit.

SLMA strongly supported President Reagan's successful effort to reduce federal spending by $130 billion. We again agree with the President that further reductions in federal spending are necessary to achieve a balanced budget in 1984. The psychological effect of not achieving anticipated deficit levels could be devastating in the financial markets. Achieving the Administration's forecasted deficit of $43.1 billion in 1982 is a certain way to tell the public and the financial markets that the government is getting its house in order, that it is serious about fighting inflation and curtailing spending.

SLMA intends to work vigorously for further reductions in federal spending and urges that careful consideration be given to revising the system whereby 55 percent of the federal budget is indexed. Beginning in 1985, taxes are indexed and tax revenues will not increase with inflation while spending will unless checked by statute or Constitutional amendment. Without changes, and unless there is no inflation, spending will exceed revenue and deficits will result.

In closing, Mr. Chairman, we do not expect an overnight solution to high interest rates. Neither can we wait much longer to see some improvement in the financial markets. It does no good to constigate banks and Wall Street for causing our economic dilemma. They are merely responding to current economic policies and fears of continued deficits and renewed inflation. The solution must come from you and your colleagues and it must come soon.

Again, thank you for the opportunity to address this critical issue; I would be happy to answer any questions you may have.

# # #

RACHELS

INCORPORATED

116 East 16th Avenue
CORDELE, GEORGIA 31015

August 18, 1981

Senator Sam Nunn
Senate Office Building
Washington, D.C.

Dear Senator Nunn,

On your recent visit to Cordele I had a chance to talk with you briefly concerning the devastating effects of currently high interest rates on the small businessman. I would like to expand on that.

I'm in the supermarket business. Until about three years ago I had only one store, debt free and doing very well. In 21 years it paid for itself and a home for my family. It also provided a good living for my wife and I and our four children, two of which are boys, now grown.

In an effort to provide jobs for the boys and a better income for us all, I bought out another store with a $ 575,000.00 loan, 90 of which was guaranteed by the FHA. The actual funds were to come from conventional sources. Upon advice from my C.P.A. I agreed to let the interest rate float with the prime interest rate, resetting every quarter at prime plus 1 1/2%. At the time I could have nailed the rate down with an insurance company at 11%. My C.P.A. however, contended that historically the prime averaged so much lower, that we would be better off with the float. Since that time rates have climbed fantastically and stayed high ever since.

Our current rate is 21 1/2%. We have averaged over $ 10,000.00 per month in interest cost since opening our new store. Had I known this would happen I would have never taken on such expansion. We are losing money now, not from mismanagement or lack of experise in our chosen field, but from this interest situation, over which we have no control. Had interest rates behaved normally we would be showing a modest profit instead of a loss. Many small businesses have already been forced to the wall by these circumstances. And, if relief is not forthcoming, I'm afraid that we too will soon be joining them.

Clearly something must be done about this situation or many more small business owners, the backbone of our economy, will fail. Anything that you and your colleagues on the Senate Small Business Committee can do to bring relief from this oppression will be greatly appreciated.

Thank you,

E. T. Rachels Jr.

E. T. Rachels, Jr.
President

ETR/jmt

PAUL BUSH
REAL ESTATE, INC.
BUILDER
P. O. Box 1400 — Americus, Georgia 31709
PHONE — 912-924-9364

Rentals — Apartments
Mini Storage
Office Space

HOW

Sales — Single Family Homes
Condominiums
Land - Lots

August 21, 1981

TO: Senator Sam Nunn

FROM: Paul Bush Builder & Crew

Dear Sam,

This high interest rate is killing us in the Home Building Business. Long term conventional loans for home buyers today is from 16½% to 17½% interest plus discount points from 1% to 3%. (F.H.A. and V.A. is about the same.)

A 1700 square foot, 3 bedroom house with 2 baths cost about $65,000. and we have very few people who qualify for this payment. (See Example #1)

Please give us any advise you have and we will relay it to our buyers.

Interest is also killing us on Apartments. The lowest conventional interest we can get on Apartments now is 18%. (See Example #2)

There are some things our people can do. They can go from a 3 bedroom, 2 bath house to a 1500 square foot, 3 bedroom, 2 bath condominium with all the energy features and it will cost about $55,000. We are doing this now. We have these condominiums for sale now. (See Example #3)

We are hurting very bad now, but please try to fix our problem with the Free Enterprize System and not a Government Program.

You have a tough job and we are with you 100%.

Sincerely,

Paul Bush

PAUL BUSH BUILDER & CREW

W. Frank Bush
Robert R. Kelly Sr.
Steve Driggers
Jerry Driggers
Donnie Driggers
Willie Coleman

EXAMPLE (1.) Page 1 of 2

MODERATELY BUILT 1700 SF HOUSE –

COSTING	$65,000.00
DOWN PAYMENT (10%)	- 6,500.00
FINANCE	$58,500.00

CLOSING COST (5.5%)	$3,217.00
DOWN PAYMENT	6,500.00
CASH NEEDED	$9,717.00

QUALIFICATION of Homebuyer Varies –

EXAMPLE IS BASED ON 30% GROSS INCOME ALLOWANCE FOR MORTGAGE PAYMENT, TAXES AND INS.

EXAMPLE:

INTEREST RATE 17½%, TERM 30YRS.

MONTHLY PAYMENT (on $58,500.00)	$857.81
TAXES & INSURANCE (est.)	50.00
TOTAL Mo. Payment.	$907.81

907.81 X 12 =

(ANNUAL) $\frac{\$10,893.72}{.30}$ = MINIMUM ANNUAL INCOME REQUIRED

= $36,312.00

EXAMPLE CONT.

EXAMPLE 1. CONT.

Page 2 of 2

SAME HOUSE
SAME QUALIFICATIONS
BUT WITH –
INTEREST RATE @ 13% TERM 30 YRS.

MONTHLY PAYMENT (on $58,500)	$647.14
TAXES & INSURANCE (Est.)	50.00
TOTAL Mo. PAYMENT.	$697.14

$697.14 X 12 =

(ANNUAL) $\frac{\$8365.88}{.30}$ = MINIMUM ANNUAL INCOME REQUIRED.

$\boxed{= \$27,885.60}$

SUMMARY:
BASED ON FOREGOING CRITERIOR

INTEREST RATE FROM 13% to 17½%
or 4½%

INCREASES MINIMUM SALARY QUALIFICATIONS
FROM $27,885.00 TO $36,312.00
or 30%
THUS
ELIMINATES MANY MIDDLE INCOME AMERICANS FROM AFFORDING A HOME.

Page 1 of 4

EXAMPLE (2)

1 BED ROOM APARTMENT -

COSTING	$30,000.00

INTEREST 18% 30 YRS.

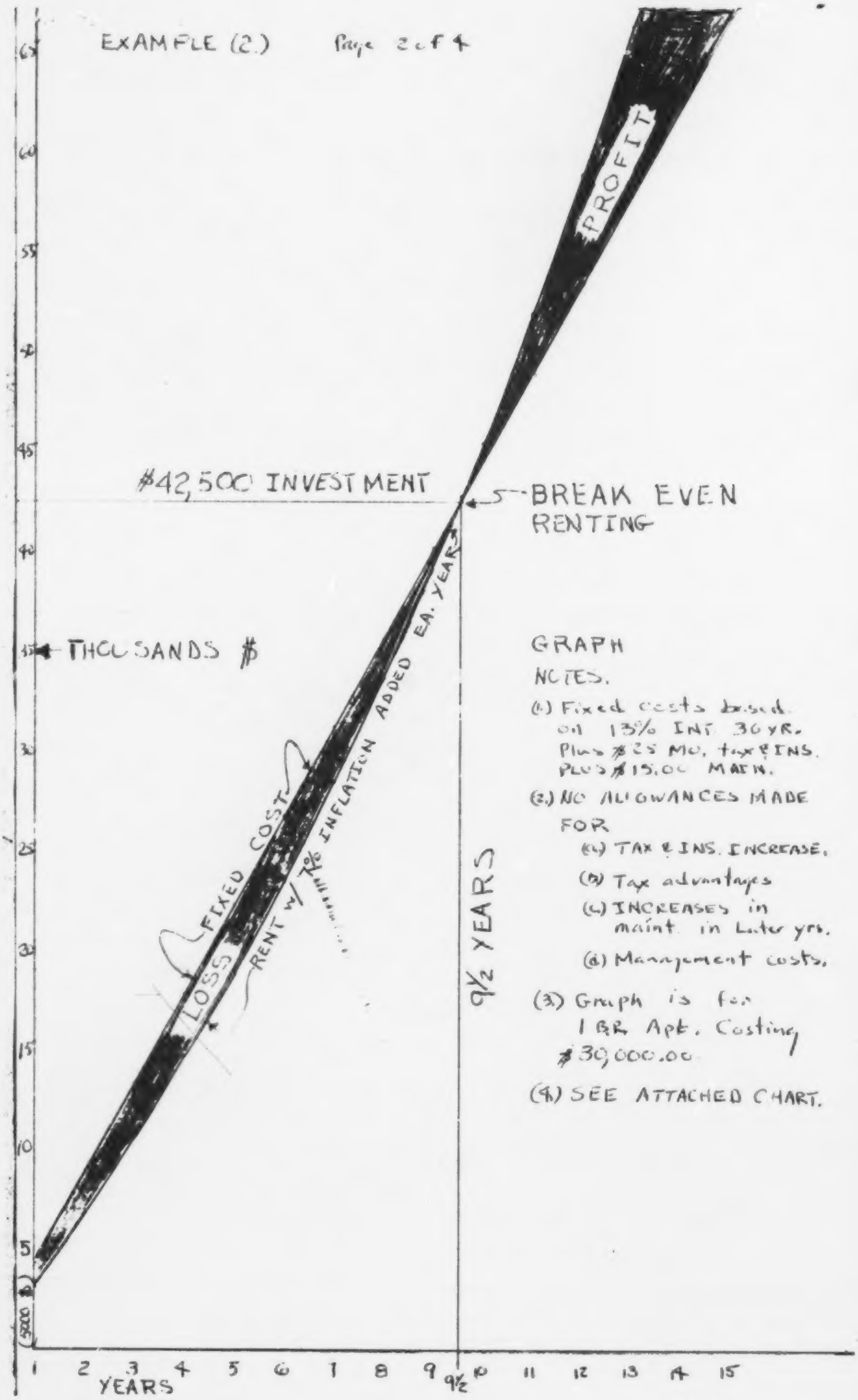
MONTHLY PAYMENTS	$452.00
TAXES & INSURANCE (est.)	25.00
MAINTAINENCE	15.00
COST PER MO.	$492.00
INCOME (RENT)	$275.00
LOSS PER UNIT PER MO.	$217.00

WE HAVE 16 OF THESE UNITS x 217 = $3,472/MO.

BUT, WITH INTEREST @ 13%

MONTHLY PAYMENTS	$331.86
TAXES & INSURANCE	25.00
MAINTAINENCE	15.00
	$371.86
INCOME (RENT)	-275.00
LOSS PER UNIT PER MO.	$96.86

BUT EVEN WITH 13% INTEREST and provided we have moderate inflation which will allow us to raise the rent at the rate of 7% per year, it will take us approximatly 9½ YEARS to BREAK EVEN and start making a profit.
SEE ATTACHED GRAPH & CHART.



EXAMPLE (2.) Page 2 of 4

GRAPH NOTES.

(1.) Fixed costs based on 13% INT. 30 YR. Plus $25 MO. tax & INS. PLUS $15.00 MAIN.

(2.) NO ALLOWANCES MADE FOR
  (a) TAX & INS. INCREASE.
  (b) Tax advantages
  (c) INCREASES in maint. in Later yrs.
  (d) Management costs.

(3.) Graph is for 1 BR Apt. Costing $30,000.00

(4.) SEE ATTACHED CHART.

INTENTIONAL

BLANK

EXAMPLE (2) Page 3 of 4

YEAR	RENT/MO.	RENT/YEAR	TOTALS	COSTS/MO	COST TOTALS	YEAR END TOTAL PROFIT-LOSS
1	$275	3,300	3,300	372	4464	(1,164.00)
2.	294	3,528	6,828	372	8928	(2,100.00)
3	315	3,780	10,608	372	13,392	(2,784.00)
4	337	4,044	14,652	372	17,856	(3,204.00)
5	361	4,332	18,984	372	22,320	(3,336.00)
6	386	4,632	23,616	372	26,784	(3,168.00)
7	413	4,956	28,572	372	31,248	(2,676.00)
8	442	5,304	33,876	372	35,712	(1,836.00)
9.	473	5,676	39,552	372	40,176	(624.00)
10.	506	6,072	45,624	372	44,640	984.00
11.	541	6,492	52,116	372	49,104	3,012.00
12.	579	6,948	59,064	372	53,568	5,496.00
13	620	7,440	66,504	372	58,032	8,472.00

~~88-231 407~~

EXAMPLE (2) Page 4 of 4

THEREFORE, at 18% INTEREST, we may conclude that the cost and rent lines would not intersect so that a profit could be realized.

Page 1 of 2

EXAMPLE (3)

3 BED ROOM CONDOMINUM

COSTING	$55,000.00
DOWN PAYMENT (10%)	- 5,500.00
FINANCE	$49,500.00

CLOSING COST (5.5%)	$ 2,723.00
DOWN PAYMENT	5,500.00
CASH NEEDED	$ 8,223.00

QUALIFICATION of Home buyer Varies —

EXAMPLE IS BASED ON 30% GROSS INCOME ALLOWANCE FOR MORTGAGE PAYMENT, TAXES AND INS.

EXAMPLE :

INTEREST RATE 17½%, TERM 30 yrs.

MONTHLY PAYMENT (on 49,500)	$725.83
TAXES & INSURANCE (est.)	42.00
TOTAL Mo. Payment	$767.83

767.83 X 12 =

$$\text{(ANNUAL) } \$\frac{9,213.96}{.30} = \text{MINIMUM ANNUAL INCOME REQUIRED}$$

$$= \boxed{\$30,713.20}$$

cont.

Page 2 of 2

EXAMPLE (3) Cont.

SAME CONDOMINIUM
SAME QUALIFICATIONS
BUT WITH -
INTEREST RATE @ 13% TERM 30yrs.

MONTHLY PAYMENTS (on 49,500)	547.56
TAXES & INSURANCE (est)	42.00
TOTAL PAYMENT	$\boxed{\$589.56}$

$589.56 X 12 =

$$\text{ANNUAL } \frac{\$7,074.72}{.30} = \frac{\text{MINIMUM ANNUAL}}{\text{INCOME REQUIRED}}$$

$$\boxed{=\$23,582.40}$$

PAUL BUSH
REAL ESTATE, INC
BUILDER
P. O. Box 1400 — Americus, Georgia 31709
PHONE — 912-924-9364

Rentals — Apartments
Mini Storage
Office Space

August 19, 1981

TO: Farmers Home Administration

FROM: Paul Bush Company

PLEASE DO NOT KILL THE FREE ENTERPRIZE SYSTEM.

Our Government is using our hard-earned tax money and putting us out of business. Our company has been in business in Americus since 1950. Most of the time we have had about 40 people on the payroll. We all live here, in Americus, and want to keep eating here.

In 1975, a HUD Housing Project, Southland Heights Apartments on the Vienna Highway, was allowed to be built in Americus that was in direct competition with our business. This HUD Project did very poor, having less than 40% of these units occupied one year after completion, even with our Government money. Our conventional apartments, approximately 100 units, dropped from 95% occupancy down to 47% occupancy.

This 515 Farmers Home Government Project you are planning to build on U.S. 19 on Meadowbrook Drive, in Americus is also in direct competition with our business.

Please do not allow this project to be built.

PAUL BUSH COMPANY

Paul Bush
Brenda Crawford

cc: Senator Sam Nunn

James E
Terry Driggers

GEORGIA CREDIT UNION LEAGUE, INC.
P. O. BOX 29884 / ATLANTA, GEORGIA 30359 / PHONE 404 634-4256 1 800 282-6243

September 21, 1981

Honorable Sam Nunn
United States Senate
Washington, D.C. 20510

Dear Senator Nunn:

Thank you for your letter of September 2, 1981 inviting our league to submit a written statement to the Senate Small Business Committee. I have enclosed a written statement.

We very much appreciate this opportunity and your concern for the well being of the credit unions of Georgia.

Sincerely,

John I. Beck, Jr., CAE
President

JIB/rb

cc: Walter J. Culpepper, Chairman
Georgia Credit Union League

Senators, the Georgia Credit Union League appreciates this opportunity to relate the experience and consequences that high interest rates are having on Georgia's 480 state and federally chartered credit unions and their 775,000 members.

High interest rates are a welcome event to savers because they are now able to receive near market rates for their savings. A rush of money from the historically stable passbook accounts to the higher yielding, more volatile, newly-created savings certificates and money market mutual funds has been the most significant change in the consumer saving pattern I have witnessed in years. Saving is now clearly more profitable.

However, the correlary to this is that credit unions must earn more interest on loans and other investments to provide those high savings rates. I mention the category of "other investments" since this is money not placed into consumer loans. Furthermore, deposits lost to money market mutual funds is money diverted away from auto, mortgage and home improvement loans.

The impact of the more volatile savings pattern, plus loss of savings to non-consumer lending entities like money market mutual funds, has been a decline in availability of less-expensive money for loans. This fact, in combination with unprecedented inflation, increasing federal deficits and increased risks of lending (in combination with changes made through the Bankruptcy Act of 1978), has acted to price the cost of money beyond levels that are affordable by most individuals.

Just the other day, the credit union manager of a defense credit union told me that his average car loan is running $228.00 per month. For enlisted personnel, this is an impossible payment. For any family -- yours or mine -- such high monthly payments for transportation, just one item in the family budget, are a heavy burden. It's no wonder that car sales are off and that the economy is generally sluggish. I can tell you that the demand for loans in credit unions is down by about 20% over similar periods in the past few years. With this slackened demand, you might think that credit union lending rates should fall. However, there is little room for rates to fall. In order for us to keep our savers (for credit unions, our only source of funds), we must charge 12%-15% or higher on loans.

The 20% prime lending rate we see today is, I believe, abnormally high and not entirely justified by the cost of money. However, it does accurately reflect, I suppose, a lack of confidence in the financial markets over rising federal deficits and the demand for more credit by the federal government -- credit required to service the soon-to-be $1 trillion in federal debt. It will take $108 billion to service that debt in 1982.

Once confidence is restored, and the financial institutions, borrowers and lenders become acclamated to the new unregulated interest rate environment, I believe interest rates will fall and approximate what credit unions are now charging on loans. I say this because credit unions are unique. They are controlled and operated by their own members. They determine the savings rates they offer and they determine rates on loans. They, themselves, balance the cost of funds with the members' demands for credit and the need for loans. While credit union rates are higher than they have ever been, they remain lower than the prime rate and are not as sensitive to market fluctuations.

In summary, I would like to make these points:

1. We favor an environment where the federal government does not regulate interest rates; therefore, we favor the elimination of Regulation Q. We do note, however, that deregulation of lending rates must also occur. So we oppose usury ceilings as obstacles to an unregulated market, unnecessary because of more adequate disclosure to consumers of interest rates and finance charges mandated by the Truth-In-Lending Act.

2. Lowering interest rates can be aided by Congress rewriting portions of the Bankruptcy Reform Act of 1978, which unfairly increased the ability of some to walk away with the savings of others. It only takes 5 or 10 people who know the loopholes, or to be influenced by a lawyer's ad in

the newspaper, to short-change the financial institutions $30,000-$40,000. This forces credit unions to keep rates high to cover otherwise unnecessary losses. To correct this problem, Congress need merely permit bankruptcy judges to determine the necessity for an individual to claim Chapter VII. Congress should also make it easier to pay back some or all of the loan, reaffirm that debt, if the Bankrupt so desires and if it is in the Bankrupt's best interest.

3. The federal government should continue its trend toward a more responsible fiscal policy, lowering the federal deficit and keeping federal spending down.

4. In the concern over interest rates, don't abandon the fight against inflation. The federal government has been fighting inflation since 1966 when it imposed (for the first time) interest rate controls on savings. This was meant to help keep the cost of money and housing down. This now has caught up with us. Inflation is a #1 concern for institutions, such as credit unions, which promote thrift. A recent Newsweek article correctly labled inflation as the "neutron bomb of economics". It destroys the value of money but leaves the numbers intact. This is quite correct and inflation is still perceived to be the largest component of the current high interest rates.

We appreciate this opportunity to present these views.

I would also like to make available to the Committee a recent interview with Henry C. Wallick, a governor of the Federal Reserve Board. Mr. Wallick was interviewed by the Credit Union National Association and expresses his views on the subject of high interest rates. We concur with those views.

John I. Beck, Jr., CAE
President, Georgia Credit Union League

September 21, 1981

INTERVIEW WITH
HENRY C. WALLICH AND
CREDIT UNION MAGAZINE

1. Q. Why are interest rates so high?

A. Because inflation is so high.

Q. But recently inflation has come down, but interest rates have stayed up. Why?

A. Well, interest rates don't move with inflation day by day. You can't be sure that inflation has come down reliably. It has come down a little, but we've also had some special luck. There is an oil glut around the world, we've been fairly lucky on crops. That has helped us, but the underlying rate of inflation which really depends on wage increases and productivity gains has come down very slightly. It's still in the 9-10% range.

2. Q. How high do you think interest rates will go?

A. I hope they won't go any higher. It depends on our policies. They have to be directed to getting the inflation down. Now, in addition to that you can save yourself some agony by reducing the demand for credit, and the principal demand for credit that can be reduced is that of the federal government because it's the biggest single borrower. If we could get the government to balance the budget, the government would borrow less and there would be more left for others, so interest rates wouldn't have to be so high to squeeze out other borrowers.

Q. What would you do if you were President Reagan?

A. I would try to balance the budget as early as possible. I would take out whatever I would lay my hands on. I would cut entitlement programs, cut defense some, and I think about the need for another tax or slowing of the present tax cuts.

4. Q. Would you recommend that people should be saving more and spending less?

A. I certainly would, and I can do this with much better conscience now that they can get better interest rates than they could before. I can also tell them that if they did go to borrow now, they would pay high interest rates, so it is better not to borrow. But people don't listen to advice, they listen to the market and the market has put a heavy penalty on borrowing, and given a reward to savings.

5. Q. Why has Wall Street's reaction been so negative?

A. Because they see this large deficit resulting from the tax cuts. They don't want to be told that the budget will be balanced, they want to see it balanced.

6. Q. The Fed is supposed to be independent of politics, but many people believe that sooner or later it shapes its monetary policies to match the President's programs and meet his political needs. What's your view?

A. That's not my experience, but you're welcome to interpret things as you like. I have never been exposed to any kind of pressure, and I have no interest in electing any particular kind of President. I don't believe that by raising the money supply at a particular time you immediately elect somebody or the reverse.

7. Q. Do you think one single super financial regulatory agency is likely to exist in the future?

A. That's been suggested many times, but I'm not at all enamored with the concept. It makes me think that we probably have two central banks -- one, the Fed, that controls the money supply and the other, the super agency, that controls such things as capital ratios with banks and maybe credit allocation. I'm saying it would be undesirable to have one super regulator who would then be so powerful as to be a new kind of central bank.

8. Q. If you were a CU manager and most of your deposits shifted overnight from a 7% share account to a 12.6% All Savers certificate, what would you do?

A. Well, I don't want to advocate raising the rates that you charge, but to the extent that the whole rate structure, both for what you pay and what you charge has been based on underpaying the saver, not paying him the living wage so to speak, I think that the saver has had a very poor deal and the borrower has had a very good deal particularly since he can deduct the interest he earns. So, even if you lend at 10 or 12 percent, basically most borrowers are paying a negative real rate.

9. Q. What do you mean by negative real rate?

A. The real rate is the rate you pay after deducting inflation. Negative, of course, is less than zero. Borrowers have been getting more than free money, they've been subsidized.

Q. Clearly, in your view, this has to change?

A. Well, it is changing, and in many cases it's very painful. We are so accustomed to subsidizing a borrower to exploiting the lender that when the market finally tries to deal with that or when the Congress finally tries to alleviate it we think this is the disturbance of an old established relationship and shouldn't be, but one has to conclude that the way it's worked out hasn't been fair. So long as we had stable prices and no inflation everything was fine. The nominal interest rate was equal to the real rate, and even though you paid tax on what you got, you still had a positive real rate of return. But inflation has the effect of not only reducing the real rate, but also of making the tax gimmick more powerful.

11. Q. Do you think CUs should make more use of the access they have to the federal discount window?

A. Well, as you know, we don't lend to banks and thrifts for profit, we lend to them in order to help them get through a liquidity problem. The point is not to get cheap credit from us, but to cover a situation that they could not easily cover from their own resource. So I wouldn't advise anybody to try to borrow needlessly.

12. Q. Given the growing influence of the Fed on CUs, do you think you would support soon a CU person to become a governor?

A. I don't dispose of these things. The President appoints. I would not like to see a representative of a particular interest group on the Board. I don't regard myself as representing any particular body or any state.

13. Q. Do you think CU should play more of a political role in this country?

A. You represent a very important institution in this country. It has its counterparts abroad; for example, in Germany one of the most powerful voices against inflation there is the savings bank organization. The head of that organization is a political force. When he speaks to the German legislature and to the German government, they listen.

14. Q. There's a growing belief that the present financial regulatory structure is inflexible and that a substantial reorganization of the system is overdue. Do you share this view?

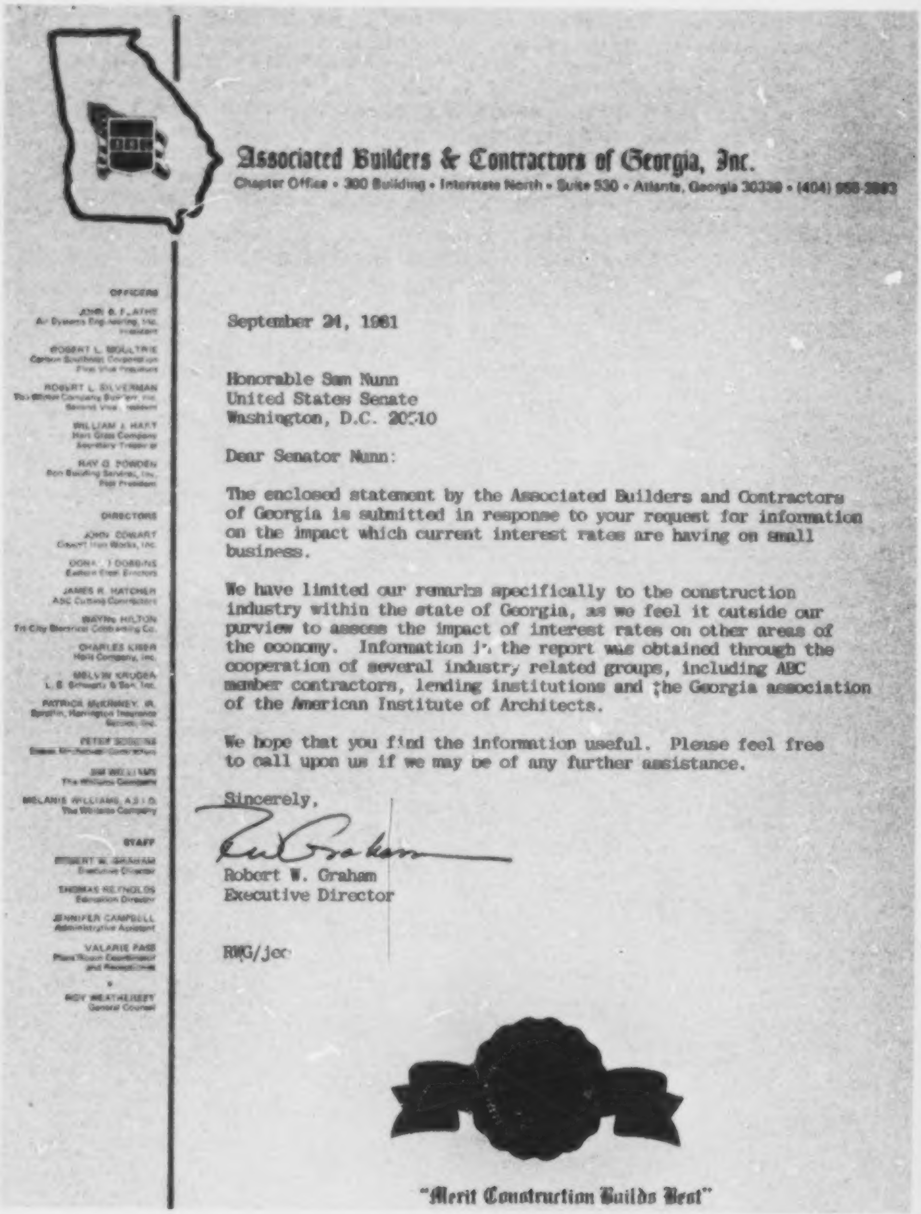
A. Some legislation is needed to cope with the problems of the thrift industry. Right now we do have them suffering from the low interest rates on their old mortgages and the high interest they have to pay to attract deposits. The All Savers certificate should help them some. The Fed is ready to help those that have liquidity difficulties. I also think some broadening of their powers is desirable. It will make them more like banks, so that means that banks, too, need something. In fact, this seems to be as good a time as any to give all financial institutions the same powers.

15. Q. Do you think CUs and other small institutions will be hurt by Congressional action to give all financial institutions similar powers?

A. I think that the fear that small institutions will be severely hurt by this is much exaggerated. It turns out it still takes the same amount of floor space for an employee to cash a check in a small office than in a large office, and so large outfits do not have much advantage over small ones. That's the basic reason why small institutions can fend for themselves.

16. Q. Will credit unions be able to fend for themselves in the future if they have no special powers?

A. I think so. It seems to me there should be free competition among types of institutions just as there should be free competition in any one particular type of institution. So long as there is always this pulling and hauling among different forms of credit institutions, each trying to protect its own turf, trying to encroach a little on the turf of the other, you get the feeling that the functions of these institutions is to prey on the public rather than to serve them.



Associated Builders & Contractors of Georgia, Inc.
Chapter Office • 300 Building • Interstate North • Suite 530 • Atlanta, Georgia 30339 • (404) [illegible]

September 24, 1981

Honorable Sam Nunn
United States Senate
Washington, D.C. 20510

Dear Senator Nunn:

The enclosed statement by the Associated Builders and Contractors of Georgia is submitted in response to your request for information on the impact which current interest rates are having on small business.

We have limited our remarks specifically to the construction industry within the state of Georgia, as we feel it outside our purview to assess the impact of interest rates on other areas of the economy. Information in the report was obtained through the cooperation of several industry related groups, including ABC member contractors, lending institutions and the Georgia association of the American Institute of Architects.

We hope that you find the information useful. Please feel free to call upon us if we may be of any further assistance.

Sincerely,

Robert W. Graham
Executive Director

RWG/jec

"Merit Construction Builds Best"

STATEMENT OF THE ASSOCIATED BUILDERS AND CONTRACTORS OF GEORGIA

The Associated Builders and Contractors of Georgia is the state organization of the Associated Builders and Contractors, Inc., a nationwide construction trade association with over 17,000 member firms in seventy three local chapters throughout the United States. Its membership includes general contractors, subcontractors, suppliers and associates. The Georgia chapter of ABC currently has over two hundred and fifty member firms in the association and is the largest construction industry group of its kind in the state.

Its diverse membership makes it highly representative of the construction industry as a whole. Two members of its Board of Directors represent companies on the Engineering News Record (ENR) "400" list of the nation's largest contractors, and it counts five such firms among its general membership, including the nation's largest minority owned construction firm. It represents a broadly based group of general contractors and subcontractors within the state, most of which would fit the profile of ABC membership nationwide recently published by the Opinion Research Corporation of Princeton, New Jersey.[1] The members of the Georgia chapter of ABC are engaged wholly in the commercial and industrial construction fields, with no homebuilders represented in its membership.

There is no denying that within the state of Georgia the construction industry and its ancillary service and supply industries are being seriously damaged by high interest rates. While the impact within the state is not as severe as in some other Southeastern areas (Mississippi's 1981 construction volume is currently off 67% from 1980) it is, nonetheless, substantial.

In examining the effect current interest rates have on the industry, it is important to note the dual impact of the rates on ABC members and the several levels within the industry at which this impact is felt.

High interest rates impact those in the construction industry in two ways. First, the rates inhibit banks from loaning money to small businesses,and over 80 percent of Georgia ABC members are small businesses. Second, high interest rates inhibit construction buyers from putting projects out for bid. This is especially true in commercial and light commercial construction, which is performed by the majority of Georgia ABC members. While many ABC members build for large companies, most of their work is for small entrepreneurs like themselves.

Many of these projects have all but ceased to exist due to the current interest rate structure. The Georgia Association of the American Institute of Architects reports that several areas within the state have been severely affected by the rates. Private development in the Augusta area has come to a virtual standstill. Fifteen AIA member firms in the Middle Georgia (Macon) area report that they have had work on muti-family, commercial, institutional and health care facilities either delayed or abandoned due to high interest rates, and an Atlanta based firm has had a fifty million dollar hotel project delayed.

The affect of the interest rates on the "first step" in the construction process - that of the owner deciding to build - is perhaps best summarized by the following statement from a large Atlanta based design firm:

"A significant proportion of our work for several years had been generated by independent developers. That segment of our practice is noticeably down this year. Our prospective clients tell us the rental they would have to charge to pay debt service could not be competitive; therefore, they are either waiting or arranging joint ventures with insurance lenders in a few cases.

Institutional work for public schools, libraries, and administration buildings is almost dead due to unsuccessful bond referendums. Fulton County, the one Metro County to succeed in 1981, has had to sell its bonds for a higher rate than anticipated and, therefore, cannot build as many schools as scheduled."[2]

With the construction industry being as diversified as it is, high interest rates impact it at several levels, with a correspondent widespread "ripple" effect. These levels include the owner who makes the decision to build or not based upon the cost of money; the design firm for the project; the contractors, both general and subcontractors, who build it; the suppliers of material and associated services to the industry and the lender of funds themselves.

From the perspective of the lender, the interest rate effect on the type of projects normally funded through alternative financing, such as below market loans provided through the Government National Mortgage Association (GNMA) has been to close down alternative tax exempt mortgages from one side while facing cutbacks in the federally financed programs on the other.

Trust Company Mortgage[3] reports that tax exempt mortgage rates are as high as 14 to 15%. The last GNMA funds were made available in January of 1981, but were sufficient to fund only approximately one half of all eligible projects, and it is expected that the 1982 housing budget will be sufficient for less than half of the eligible projects.

Trust Company Mortgage also reported that there are currently eight HUD approved Market Rent Projects (no rent subsidy) totaling some thirty four million dollars in construction volume and five 100% Section eight projects with a volume of twelve and one half million dollars, currently infeasible due to high interest rates. The projects are located throughout the state and include areas such as Brunswick, Milledgeville, Macon, Atlanta, La Grange, Thomaston and Rome.

Due to the nature of their particular role within the construction industry, many general contractors are not as directly affected by interest rates as are subcontractors, who often have a large investment of capital expenditures in materials and equipment.

A medium sized ABC electrical subcontractor[4] based in Atlanta reports that they have limited all capital expenditures as much as possible until their fiscal year end (October 31, 1981) in hopes that the interest rates will drop. Indicative of the previously noted "ripple effect", these items include heavy equipment (trucks), a computer and office equipment totaling over ninety two thousand dollars. In construction contracts, they reported that some four hundred and seventy thousand dollars in electrical subcontracts on three Atlanta area commercial projects which they were involved in were either delayed or abandoned due to the owners hesitancy to proceed based upon current market interest rates.

Also noted was a substantial increase in the number of collection days on accounts receivable, a crucial factor for many smaller construction firms. From December 1980 to August 1981 the average number of collection days for many firms has increased from twenty seven days to forty one days, causing attendant slow downs in cash flow and thus payments to suppliers and other creditors.

In summation, while many construction industry firms are affected by the general slow down in the economy as it applies to delayed or postponed projects, either on the public or private sectors, they are also severely impacted by the pure cost of money itself. As noted in the findings of the House Committee on Small Business, many smaller construction firms pay substantially more than the prime rate for available funds. The subcommittee, in its report, noted:

"The prime rate does not indicate a preferred, short term rate that a bank affords to its most credit worthy customers. In tight money periods, large banks lend a significant amount of short term, large sized loans to large businesses. On the other hand, companies with less than one hundred employees pay rates well in excess of prime. This has an adverse effect because many smaller firms have loan agreements tied to the prime rates. Additionally, the prime rate lags other short term market rates and work to the relative disadvantage of customers who do not have access to the open market for short term credit."[5]

For some construction firms with heavy investment in equipment and materials, such as highway and road building contractors, this resulting debt service can be enormous. One such contractor, with equipment loans marked at two percent above prime, reportedly has an interest debt service alone of over four hundred thousand per year due to the current prime rates.

Should interest rates remain at their present level, it is expected that the construction industry in Georgia will continue at its sluggish pace and that there will be a substantial increase in the number of smaller firms which will be forced to go out of business due to the slowdown in both government and privately financed construction. At best, many firms now have work scheduled through the first thirty to sixty days of 1982, with no significant new projects on line beyond this time frame.

1. BNA Construction Labor Report, Number 1345, September 16, 1981 (A-3).

2. AIA, Atlanta Chapter, letter dated 9/17/81.

3. Trust Company Mortgage, Atlanta, letter dated 9/10/81.

4. Belco Electric, Atlanta, letter dated 9/16/81.

5. Report of Committee on Small Business: Federal Monetary Policy and its Effect on Small Business, report number 96-1435, 9/30/80, page 44.

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

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September 28, 1981

The Honorable Sam Nunn
United States Senate
Committee on Small Business
Dirksen Building - Rm. 3241
Washington, D. C. 20510

Dear Senator Nunn:

The Associated General Contractors of America is pleased to respond to your request to submit a statement for the record for the Senate Small Business Committee's hearing on "Interest Rates and Business Credit Needs".

High interest rates are of great concern to the construction industry. AGC has supported the President's Economic Recovery Program already approved by Congress in the belief that the tax cuts, budget expenditure reductions and regulatory relief will restore the U. S. economy to robust health and also result in reduced interest rates.

We believe that the current high interest rate structure has its roots in government living beyond its means, incurring debt that has almost unbearable debt service and competing with the private sector for its borrowing.

We believe that the construction industry has been impacted more than any other industry by the spending cuts already approved by Congress. We supported those cuts to demonstrate the degree of our concern about high interest rates, to help return our economy to health and our government to spending it can afford.

During the past few years, we have repeatedly advised Congress, the Carter Administration and the Reagan Administration of the inflationary impact of excessive and needless regulation including Minority Business Enterprise quotas and goals that are really quotas, SBA programs, such as 8(a), that are devastating small businesses, and a host of other social engineering activities that squander tax dollars without achieving intended results.

At long last, we have an Administration that is addressing some of those problems it inherited. We hope its policies will also reduce interest rates because our industry already overburdened by social engineering is being heavily impacted by the current cost of capital.

Sincerely,

Hubert Beatty

Hubert Beatty
Executive Vice President

HB/fds